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Exhibit 1

THE RUSSIA JOURNAL

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SPECIAL REPORT: Banks rebound, but reform slow in coming

By SCOTT BUGIE / Special to The Russia Journal

Russian banks have risen from the depths of the economic and financial crisis that started in August 1998.

The domestic economy is expanding steadily for the first time in years. Bank balance sheets and business flows moved upward throughout the year 2000 and into 2001, rebounding from the difficult period of absorbing the shock of the collapse and massive bank failures triggered by the crisis.

But no fundamental changes in the Russian banking industry have occurred since then. The retail giant Sberbank continues under state control, private-sector banks remain beholden to the interests of their industrial shareholders, the legal and regulatory environment is still weak and arbitrary, financial disclosure limited, and little foreign direct investment (with corollary inflow of technology and know-how) has come to Russian banks. Russian credit culture remains stunted. A consequence of these factors is that banking intermediation, essential for the efficient accumulation and reinvestment of capital, is woefully undeveloped in Russia, and banks continue to carry a higher degree of credit risk than in almost any other country in the world (see table for list of Russian bank Counterparty Credit Ratings).

The banking industry is one the weakest economic sectors in the Russian Federation. Several factors hinder its improvement (See table below).

The Russian banking system has survived three major crises in its short life since the end of the Soviet Union a decade ago. The first was "black Tuesday" in November 1994, when the bottom fell out of the ruble. The second was the liquidity crisis in the interbank market of August 1995. The third crisis was the government's default on its ruble bonds and the subsequent ruble devaluation in August 1998.

Most banks in Russia defaulted in the weeks and months following the 1998 crisis; recovery of the banking system began only in the second half of 1999. While the Central Bank withdrew the licenses of many banks after the crisis, the restructuring of the largest failed banks was and has been extremely slow and uneven. SBS-Agro is the most notorious example of this. Survival has depended largely on the strength of a bank's political connections and links to industrial concerns as opposed to Central Bank policy.

RUSSIAN BANKING INDUSTRY LAGS

Russia's banking sector lags that of other transition economies — for example, Bulgaria, Hungary, Kazakhstan, Poland and the Baltic countries — in several key areas. Firstly, in contrast to the situation in these countries, the large state-owned banks in Russia have not been privatized.

Consequently, Vneshtorgbank, and savings bank Sberbank in particular, dominate the retail and corporate banking markets. Both these banks have aggressively expanded business since the second half of 1999. Sberbank benefits from a perceived (but not real) government guarantee on its deposits and the confidence of retail customers, who avoid entrusting their money with private-sector banks.

Its network of 24,500 branches and sub-branches across the Russian Federation dwarfs that of the rest of the sector combined. Sberbank consequently commands over 70 percent of the retail deposit market

in Russia (and takes in a monopolistic 86 percent of ruble-denominated retail deposits). Private-sector banks cannot compete on price with Sberbank, in either deposits or lending rates, and must concentrate on better service in order to win business. Sberbank also is the only bank in Russia with enough lending capacity to satisfy the large industrial companies that dominate the economy.

Secondly, limited foreign investment has come to the Russian banking sector, in contrast with the recent history of Bulgaria, Czech Republic, Hungary, Poland, Romania and the Baltic States, among other Central and Eastern European (CEE) countries, where foreigners now control over half the banking market. Russian banks remain in the hands of the government and private domestic companies, themselves usually controlled by a handful of principals. The benefits of foreign direct investment — notably, increased capital and management know-how — have not flowed through the Russian banking system, in contrast to neighboring CEE countries, where foreign direct investment has accelerated the pace of banking reform.

Lastly, the Russian system is highly fragmented and has remained largely unchanged over the past several years. In most transition countries, governments and bank regulators enacted bankruptcy and regulatory reforms, while pushing on several fronts for banks to consolidate regulatory seizure and forced restructuring of failing and uneconomic banks, elimination of restrictions on foreign investment and privatization.

It is telling that the wholesale collapse of the Russian banking system in August 1998 did not result in the creation of larger private sector banks. In many cases, the principals of major failed institutions, such as SBS-Agro, Rossiysky Kredit and Menatep, simply transferred assets out of the failed banks to "bridge" banks they also controlled. Creditors of the failed banks were left with just a few kopeks on the ruble. Russian corporate and banking law was not able to manage in an orderly way the bank failures from the most recent crisis.

The history of the domestic forward foreign exchange and option contracts written before the 1998 crisis further illustrates the weakness of the Russian legal and regulatory infrastructure. Authorities in Russia have not been able to settle claims arising from these contracts, now outstanding and unsettled since the crisis. The legal standing of the claims remains unclear; some Russian courts have declared the unsettled forward contracts to be unenforceable gaming contracts. In the absence of any clear ruling, market participants have settled bilaterally on a case-by-case basis, or ignored the issue entirely, waiting for the three-year statute of limitations on the claims to take effect.

RUSSIAN BANKS RATED BY STANDARD & POOR'S	
Current rating in foreign and local currencies (LT/ShT Outlook)	
Alba-Alliance	CCC-/C Negative
Alfa Bank	CCC+ /C Stable
Bank Imperial	D/--
Bank Rossiysky Kredit	D/--
Incombank	D/--
Infobank	CCC-/C Stable
Investment Banking Corporation	CCC-/C Stable
Mezprombank	CCC+ /C Stable
Petrocommerce	CCC/C Stable
SBS-Agro	D/--
For more details, please refer to Russian-language Website www.standardandpoors.ru	

Due to the passage of time and the expectation that no further resolution will occur, Standard & Poor's has lifted SD, or selected default ratings, on banks that have not settled their forward contracts. The SD ratings came to lack relevance in the context of the market, which seeks an opinion on the ongoing creditworthiness of the banks. Nonetheless, the inability of the Russian courts to resolve this issue exemplifies the country's weak and arbitrary legal system — a negative factor constraining the credit ratings of all Russian entities.

FINANCIAL-INDUSTRIAL GROUP MODEL DISFAVORS BANKS

Russian banks continue to be undercapitalized, despite some capital coming recently from industrial enterprises, mainly in the oil and gas sector. In addition, international borrowings remain unavailable, while total deposits are increasing at a slow pace. The absence of longer-term funding, even in the one- to six-month maturity range, is a serious problem for Russian banks (and the Russian economy as

a whole). The primary banking activity in Russia is processing settlements among corporations and government entities as opposed to intermediating, i.e. taking deposits and granting loans for working capital. Bank customers place short-term deposits with banks, which often on-lend the deposits at the behest of the depositor, notably for settlements with third parties and for trade finance.

Private-sector banks in Russia remain wedded to the financial-industrial group (FIG) model, which clearly has survived intact despite the shock of the crisis of 1998. The dominant strength of the oil and gas industry, and to a lesser extent the metal and armaments sectors, in Russia helps keep the FIG model in place. These industries generate all-important foreign-currency revenues and have an interest in controlling banks to optimize cash flows and reap maximum financial and political advantage from them. This is all the more true in light of Russian companies' love of elaborate tax-avoidance schemes — a captive bank is a useful tool to manage offshore cash flows. But banks are the expendable part of the FIG in Russia. In the view of the industrial powers, banks are useful for managing cash flows, but not in themselves capable of generating significant revenues. The FIG model is broadly negative for bank credit risk. Owners use banks to finance their other interests, or to fund acquisitions, creating concentrations of risk for the bank. Nonetheless, owners will likely withhold support if it would endanger core industrial holdings. Indeed, this happened in the most recent crisis, when many industrial companies abandoned failing group banks.

FACTORS HINDERING RUSSIAN BANKING SECTOR

- Lack of a clear government policy with respect to banking reform
- A large unregistered economy that does little business with banks
- Lack of trust on the part of depositors with respect to banks
- Lack of significant lending business in Russia due to excessively high credit risk
- The weak and arbitrary legal system (for example, loan collection is difficult)
- The country's immature credit and payment culture

Source: Standard & Poor's

Truly independent private-sector banks, with diversified shareholders and diversified customer bases, do not exist in Russia. Alfa Bank, the most Western-oriented of the Russian-owned banks, may have the best chance at achieving a reasonable degree of diversification and independence. But even with Alfa, the goal of building a strong branch-based commercial banking network has not yielded strong results. Alfa's profits remain concentrated in securities trading and large one-off transactions.

SIGNS OF HOPE

Russian is a relatively open economy with significant ties to global markets. The country is rich in natural resources that constitute its major exports. In the past decade, the integration of Russia into the global economy has increased progressively, despite the severe jolts along the way. The presence of international companies in Moscow and other parts of the country is well-established and appears irreversible. As Russian companies, including banks, do more business with the West, they are pushed to comply with international standards of corporate governance and financial disclosure. Indeed, more and more Russian companies use Big Five auditors and publish their accounts under IAS.

Thus, while the pace of banking reform in Russian is disappointing, external forces are pushing the some banks to accept international standards. This, coupled with the increased business flows from the economic expansion, gives some hope that the huge potential of the Russian banking industry could be achieved in the not-too-distant future. In the meantime, banking reform appears stymied and the credit risk of Russian banks remains extremely high.

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Exhibit 2

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WHO OWNS RUSSIA: Russia's banking sector. The situation today.

By MAXIM BUILOV / Kommersant-Vlast

As of Oct. 1, 2001, more than 1,300 lending institutions were active in Russia. More than half of these were at least partially owned by the state. Nobody knows exactly how many have state participation. In July of last year, the government attempted to carry out an inventory of its investments in the banking sector and counted 469 banks belonging to the state. State organizations hold controlling stakes in 36 of these banks and blocking shares in 45 of them.

The government's tally wasn't very accurate, however. Indeed, the government made no secret of the fact that it had not included banks with the Central Bank participation in its count. This meant Sberbank and Vneshtorgbank weren't on the list, nor were Russian offspring of the former Soviet foreign banks, such as Vneshekonombank.

In October, Prime Minister Mikhail Kasyanov received the list. Information on bank balances alone showed that federal and local authorities or state-owned companies had stakes in 638 banks. The state had a controlling stake in 62 of these and a blocking share in 80. When banks whose balances didn't show their links to the state were included, the total number of banks in which the state held shares or stakes rose to 679. Nothing much has changed since then, and for a simple reason: Russian bank managers seldom have a free hand to work without having to look over their shoulders at their owners.

Of all bank owners, the state is the least demanding. But those banks still in the state orbit end up having to serve their owners' interests to the full. Usually this means they have to lend to state organizations no matter how slim the chances are of ever seeing the money returned. Banks servicing the agricultural sector, for example, go bankrupt with amazing regularity no matter what name they are given, Agroprombank, Rosselkhozbank, or any other.

Other dangers may be in store for state banks. After the latest change of power at the Railways Ministry, for example, the decision was made to transfer financial flows from Zheldorbank, which traditionally serviced it, to Transkreditbank, recently bought by the Railways Ministry. But, now that Railways Minister Nikolai Aksyonenko is under investigation, this bank, too, might have to worry about its future.

The largest state banks – Sberbank and Vneshtorgbank – belong to the Central Bank. Many critics of the current system say it makes no sense to have a banking supervisory body owning banks subject to its authority, and this has aroused protests from international financial organizations that insist these banks be privatized. But the Central Bank cannot just pull out of these banks as rapidly and easily as some would like. The banks in question are too large to be sold quickly; they account for around 30 percent of assets in the Russian banking sector. The only rapid solution would be to hand the banks over to the government, for example, but this would not be the same thing as privatization and would see them remain in state hands.

Under government pressure, however, the Central Bank has had to examine its withdrawal from the capital of Vneshtorgbank and even name 2003 as a deadline for when this could actually go ahead. But this process could end up taking years. Talk about the Central Bank pulling out of Sberbank's capital has not reached any definitive conclusions yet. The problem is not just that Sberbank's assets are almost five times greater than those of the Vneshtorgbank, the country's second-biggest bank. The problem is that Sberbank holds three-quarters of deposits – 400 billion rubles in total. If depositors have even the faintest doubt that something might be up with Sberbank, they could bring it down.

There is another large state-owned bank – Vneshekonombank – but it is an exceptional case. For a start, Vneshekonombank has no license for the Central Bank to revoke. This lack of a Central Bank license also means that Vneshekonombank cannot be bankrupted, regardless of the state it is in.

Vneshekonombank cannot exactly be described as glowing with health. It carries the burden of all the former Soviet debt – trillions of rubles. Formally, Vneshekonombank is the largest Russian bank but, technically, it is not a bank at all, since it has no license. If the Central Bank

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did decide to issue Vneshekonombank a license, it would have to revoke it immediately because the law says that banks with capital sufficiency of less than 2 percent must be brought under the management of the Agency for the Restructuring of Credit Organizations (ARCO). The weight of the Soviet debt means that Vneshekonombank's capital sufficiency indicator is less than 1 percent. But the government will not allow ARCO to take over management of the debt.

If Vneshekonombank were divided into a bank and a debt agency, it would still be one of the largest in the country. In size, it would be comparable with Vneshtorgbank. This was the way that Vneshtorgbank itself appeared on the scene. Now the government wants not only to separate the banking and debt management functions of Vneshekonombank, but also to merge the resulting new bank, which would be called Vneshekonombank of Russia, with another state-owned bank, Roseksimbank.

Not only does the Central Bank participate in Vneshtorgbank's capital, Vneshtorgbank director Yury Ponomaryov is considered one of Central Bank Chairman Viktor Gerashchenko's people. Sberbank, on the other hand, though it belongs to the Central Bank, is seen as neutral, and its head, Andrei Kazmin, as loyal to everyone at once. Vneshekonombank is seen as being close to the government by virtue of the good personal relations between its head Andrei Kostin and Prime Minister Mikhail Kasyanov.

Aside from Vneshekonombank and the banks belonging to the Central Bank, the state banks included in financial magazine Dengi's list of Russia's 20 largest banks by size of assets are of two types. Gazprombank, for example, is the settlements bank for state-owned gas giant Gazprom, and the changes at Gazprom and Gazprombank that began after the departure of former Gazprom boss Rem Vyakhirev will not change this bank's status. As the bank is well-fed by Gazprom's financial flows, it has a relatively solid position. Its only real drawback is that its prosperity depends entirely on that of Gazprom, its largest shareholder.

The other category of state banks includes banks that belong to the regional authorities. Of these banks, the Bank of Moscow and Bashkreditbank are among the top 20 banks. They serve the needs of the Moscow and Bashkortostan authorities, respectively. For the Bank of Moscow, its situation depends on the personal relations between its head Andrei Borodin and Moscow Mayor Yuri Luzhkov, while for Bashkreditbank, the same goes for relations between its head Azat Kurmanayev and President of Bashkortostan Murtaza Rakhimov.

But Gazprombank, the Bank of Moscow and Bashkreditbank essentially all belong to the same category in that they are all settlement banks. The only difference between them is that Gazprombank serves the interests of a given company, while Bank of Moscow and Bashkreditbank serve the interests of the regional authorities.

State companies and regional authorities are not the only ones to have their own settlement banks. A number of private companies have also set up banks to serve their interests. Some of these banks are quite sizeable; Surgutneftegazbank, which serves private company Surgutneftegaz, is one example. But large banks of this type are the exception rather than the rule.

Settlement banks account for a large chunk of the Russian banking sector overall. Most of them are small- or medium-sized – logically enough, given that most companies in Russia are small- or medium-sized. The founding companies themselves prevent these banks from expanding, as they prefer to deal with a bank that is small and free of problems.

Some of the large banks such as Trust and Investment Bank and Menatep St. Petersburg, which traditionally serve the interests of the Yukos oil company and Rosbank, which serves the Interros Group, can also be put in the settlement banks category. But these banks, though closely linked to their founding companies, have also worked to develop business with other clients as well. The same goes for Alfa Bank, which serves the interests of Alfa Group.

All these banks have one thing in common: They are all old banks, by Russian standards. They had all reached a considerable size before the banking crisis of 1995. The main difference between them and classic settlement banks is that it was they (or the banks whose business they inherited) who bought up companies and created holdings, rather than the other way round. Since the time they were acquired, these companies have grown and are now much larger than the banks that once created them.

For example, Mikhail Khodorkovsky, when he was head of Menatep Bank, the successor of which is Menatep St. Petersburg, acquired major oil company Yukos at a loans-for-shares auction at the end of 1995. He then organized the Rosprom Group, which he heads, bringing Yukos and Menatep under the new group's control.

Another example is Vladimir Potanin, who quit his job as president of Oneksimbank, the successor of which is Rosbank, to become first deputy prime minister. It was in this capacity that he organized the loans-for-shares auctions. At one of these auctions, Oneksimbank acquired Norilsk Nickel. After his spell in the government, Potanin returned as head of Oneksimbank. Like Khodorkovsky, he decided to become head of the group he had established and, in April 1998, traded the job as bank head for that of head of Interros, of which Oneksimbank is a part.

Of all the acquisitions made by head of Alfa Bank Mikhail Fridman, Tyumen Oil Company (TNK), the ONAKO oil company and VimpelCom are the most prominent.

Until the 1998 financial crisis, the large banks actively bought up shares in less-well-known companies all around the country, usually with speculation in mind (it wasn't their aim then to create financial-industrial corporations or holdings). The end result was the emergence of various large and not-so-large financial-industrial groups.

This perhaps explains why, after 10 years and two crises, the banks that have managed to survive have become Russia's largest private banks. More recently, Andrei Melnichenko, who began with a currency-exchange outlet and built it up into MDM Bank, follows the same pattern. After the 1998 crisis, he created the MDM financial-industrial group. By 2000, MDM Bank was among Russia's 20 largest banks, and is still in a strong position. Avtobank recently joined this list, acquired by the Sibal Group.

The only banks that look out of place on the top 20 list today are the International Industrial Bank (MPB, headed by Sergei Pugachev) and Globex. These two banks

belong to various stakeholders, but no one owns a large stake. It is impossible to say with certainty exactly who owns the stakes and how they are distributed. It is a fair assumption that numerous small and unrelated shareholders own both banks, but this would mean that MPB, Russia's third-largest bank, does not really belong to anyone. Globex, with its 20 billion rubles worth of net assets, is in the same category. But these two banks are nonetheless an exception among Russia's big banks.

Foreign banks in Russia are a case apart. As of July 1, 2001, there were 133 banks in Russia with some degree of foreign investment. Two-thirds of these banks are located in Moscow, but only 23 of them are fully foreign-owned. In another 34, foreign investors hold more than 20 percent of shares and, in 46, foreigners hold less than 1 percent.

This explains why, in its statistical reports, the Central Bank includes among banks with foreign participation such banks as Avtobank, which counts the EBRD as a shareholder, and Vozrozhdeniye, which has the Canadian Imperial Bank of Commerce as a shareholder. The list also includes Evrofinance and Mosnarbank, which have Russian foreign-based banks belonging to the Central Bank

among their shareholders.

But when talking about foreign banks in Russia, people usually have in mind the Russian subsidiaries of large Western banks. The Russian top 20 banks list includes subsidiaries of such well-known banking groups as American Citibank, Austrian Raiffeisenbank and German Deutsche Bank. Formally, these banks are Russian legal entities, though their Russian clients think of them as fully-fledged representatives of their parent banks. In reality, when problems arise, the parent banks do help their Russian "children" so as to keep their name and reputation intact. But they are not obliged to do this, and in the event of serious difficulties can always refuse to settle the Russian banks' debts.

The only foreign bank not fully controlled by some Western group is Moscow International Bank (MMB). Several large foreign banks are among its shareholders, while Rossiisky Bank and Roszagranbank also hold stakes. But MMB does have a purely Russian shareholder – the Central Bank. The Central Bank's share is not large, however, and does not even constitute a blocking share.

But a large Western bank has begun showing an interest in MMB of late. After German HypoVereinsbank, a major shareholder in MMB, bought Austrian group Bank Austria Kreditanstalt, MMB took over Austria Kreditanstalt's Russian subsidiary. Now, if HypoVereinsbank wanted to develop its own independent business in Russia without using MMB as a base, it could do it through Bank Austria (Moscow), which it now owns 100 percent. If HypoVereinsbank weren't interested in doing business in Russia, it would not have bothered merging MMB and Bank Austria.

But even this merger didn't give HypoVereinsbank a controlling stake in MMB. The rules of the game abroad, however, are different to those practiced in Russia. In Russia, if you don't have a controlling stake in a company or bank, you can expect to be kicked out of the business at any moment. What is more, the experience at Legprombank proved that where minority stakeholders recently joined forces to remove the controlling stakeholder – even when you do hold the controlling stake – you cannot feel secure.

But in the West, pulling a cunning stunt to force someone out of business is seen as shameful behavior rather than a display of genius. Therefore, it is entirely possible that HypoVereinsbank was not in fact seeking to get the controlling stake in MMB.

Overall, foreign banks have become more active of late on the Russian market. Previously they did not make such an attempt to mark their presence in Russia. Their interest, it seemed, was only in being able to say to their clients that, since the devil had possessed them to go to Russia, they would try to serve them there.

But this situation has changed completely now. Bank Austria and Raiffeisenbank began serving Russian clients in 1999. MMB was already serving Russian clients, but after it bought Bank Austria, it stepped up work with depositors. On the household-deposits market, Sberbank is the clear leader, with over three-quarters of all deposits (none of the foreign banks have even 1 percent of the market), but on the foreign currency deposits market Sberbank has less than half of all deposits, while Raiffeisenbank and MMB have almost 2 percent each and their share has been increasing rapidly as of late.

ING-Bank has already begun following in their footsteps, while Deutsche Bank and Citibank have announced similar plans. These plans concern not only private depositors. Previously, foreign companies made up the bulk of foreign banks' clients, but now more and more Russian companies are turning to their services. Given that Russia is currently one of the fastest-developing markets, foreign banks will be set to increase their presence over the coming years.

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Exhibit 3



[Go To Best Hit]

Unclassified



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World Bank Loan to Russia To Aid in Reform of Regional Finances, Promote Small Business

CEP20020130000404 Moscow Vedomosti in Russian 31 Jan 02

[Article by Vladimir Fedorin: "Award for Merit To Oneself"--taken from html version of source provided by ISP.]

[FBIS Translated Text]

On Tuesday night, the World Bank agreed to issue Russia \$120 million for reform of regional finances. Minfin [Ministry of Finance] will give this money as a gift to the administrations which have taken up the task of bringing about elementary order in their budgets. According to expert appraisals, aside from the positive effect, the WB [World Bank] program will also have a side effect: New niches for medium-scale and small business will emerge in the "progressive" subjects of the Russian Federation.

For the past few years, the government has been extremely reluctant to take money from the WB. Even back in 2000, Minfin no longer needed large budget-replacing loans for structural reforms, and negotiations on investment loans (for example, for combating AIDS and tuberculosis or for re-settling Northern residents to oblasts with a milder climate) were accompanied by periodic scandals. The WB offered the money, but the government refused to take it.

However, this time, as they assure us in Minfin, Russia will not refuse the dollars. "The government gave preliminary approval to this program already on 6 December," says deputy head of the Minfin Department of Inter-budgetary Relations Aleksey Lavrov, who is also director of the project. And an expert who wished to remain unnamed associated the Cabinet's compliance with the fact that the project is actively supported by Vice-Premier Viktor Khristenko, who was in charge of inter-budgetary relations in Minfin in 1997-1999.

Russia will get the first \$40 million this year. The money will be handed out to five regions, which have already incurred expenses on fulfillment of the first stage of the program. The five "lucky ones" were chosen last year. St. Petersburg became the mainstay region of the project. Aside from it, Samara, Vologda and Chelyabinsk Oblasts, as well as Chuvashiya, passed the "screening process."

In February, the interdepartmental work group will name the second five. Buryatiya, Kareliya, Astrakhan, Kaliningrad and Saratov Oblasts, Krasnodar, Krasnoyarsk and Khabarovsk Krays are all aspiring to their share of

the second tranche.

The "model" program, developed by the group for promoting the project, includes around 50 directions of reform. In Minfin, this myriad is reduced to three main principles: Transparency of the budget process, changeover of budgets to Treasury fulfillment, and effectiveness of the expenditure and income policy of the regional administrations. "The main budget parameters should not have to be reviewed several times a year," says Lavrov. Minfin is also demanding that the regions transfer all hidden subsidies to clear form, including them in the list of budget obligations.

The competition commission will determine the winners, appraising not so much the current state of the budget, as the quality of the program put up for the competition, says Lavrov. Otherwise, it is difficult to explain the inclusion of Krasnoyarsk Kray in the short list, as it was forced to sequester budget-2001 and still does not have a legitimized financial plan for the current year.

Ideally, bringing about order in sub-federal finances must facilitate the life of entrepreneurs, who have no "cover" in the regional administrations. "Granting of various preferences and subsidies is for the most part not formalized, and governors make full use of this in order to keep enterprises close to them afloat," concludes the director of the Center for Fiscal Policy, Galina Kuryanskaya. "This undermines the competitiveness of companies which do not have access to the administrative resource." And a consistent course toward minimizing expenditures will allow politically unaffiliated small business to earn money on the state contract. "I think the regions will begin to hand over part of the services from the state sector to the private," says Kuryanskaya. In her opinion, among the first to be farmed out may be kindergartens, sports institutions and municipal transport.

[Description of Source: Moscow Vedomosti in Russian -- Business paper published jointly with The Wall Street Journal and Financial Times; reportedly friendly with Kremlin.]

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Unclassified

Exhibit 4

EMERGING
ECONOMIES
TRANSITION

OECD Economic Surveys

Russian Federation



Volume 2002/5 – February

II. Small business and entrepreneurship

Introduction

In virtually all of the relatively successful transition economies, new small private businesses have served as a primary engine of growth, absorbing resources from the state and former state sectors and exhibiting notable dynamism in the context of fierce competition and hard budget constraints.⁵⁴ Some studies suggest that the creation of dynamic new and usually small firms out of the “ruins” of old enterprises has been the most vital part of the overall restructuring process and productivity growth.⁵⁵ A thriving small business sector also reduces the social costs of transition by absorbing released workers from downsizing in large restructuring firms.

Despite the overall encouraging trends in the Russian economy described in the previous chapter, the climate for new private businesses and investment remains quite difficult, as evidenced by relatively limited numbers of small firms, low levels of fixed capital investment, and capital flight that still exceeds US\$15 billion a year by most estimates. Comparative empirical studies place Russia well behind most Eastern European transition countries according to basic measures of the climate for business and entrepreneurship. Frye and Shleifer (1997) first surveyed small businesses in Moscow and Warsaw, finding that the former are systematically subject to significantly more inspections, harassment, and fines. Following up on this theme, Johnson, McMillan, and Woodruff (1999) conducted a more extensive survey of new (primarily small) private businesses in Poland, Romania, the Slovak Republic, Russia, and Ukraine, finding that Russia and Ukraine lag significantly behind by a number of measures, including the ability to use the courts to settle economic conflicts, the ability to recover delinquent debts, time spent on government/regulatory matters, tax problems, inspections, and extra-legal payments and corruption. These conclusions were further reinforced in a comprehensive 1999 World Bank and EBRD “Business Environment and Enterprise Performance Survey,” which covered almost all former Soviet and Eastern European transition countries. On the basis of this study, Hellman and Schankerman (2000) constructed a comprehensive “capture index” to measure the importance of informal or corrupt relations with state organs or the courts for suc-

and the numerous so-called “administrative barriers” that would appear to be relatively more serious in Russia than in most other transition countries.

It may also be useful to distinguish relations of entrepreneurs with federal government organs, on the one hand, and with various subnational bodies on the other. But this distinction can be complicated for various reasons. First, the competencies and policies of regional and local state bodies are directly affected by federal legislation and fiscal federalist relations. This topic received detailed treatment in OECD (2000), and is taken up again in Chapter IV of this survey. Second, branches of numerous federal bodies operating in the regions can blur this distinction. Although they are formally subordinate only to the federal government, they often depend on, and work closely with, regional and local administrations.

In the past, specific programmes for the support of small businesses in the Russian Federation highlighted guarantees for commercial credit as a means of alleviating the typical severe liquidity constraints of small entrepreneurs. Given their inherent low capitalisation and high failure rate, small businesses always present relatively high credit risks. The weakness and low capitalisation of the Russian banking sector, as discussed in Chapter I, represents a further obstacle to the expansion of commercial credit in the absence of guarantees. While policies to support small businesses through credit guarantees might be effective in certain circumstances, they are exceedingly difficult to implement in an effective manner, especially in a country like Russia. Given the inherently high degree of subjectivity in the allocation of these funds, there is a great risk is that they could be used at the regional or local level for corrupt purposes or the political favouritism of certain firms at the expense of fair competition.⁹² Second, there is a high risk that entrepreneurs receiving the credits will misuse or not return the money, perhaps through a relatively costless formal or informal liquidation. The risk of non-payment faced by commercial banks in allocating credit to small businesses does not disappear when this credit is instead allocated or guaranteed by state organs.⁹³ On the contrary, to the degree that state organs offer guarantees for commercial credit to entrepreneurs, commercial banks may themselves become less concerned about such risk in the allocation of this credit. Therefore, this type of approach should be weighed carefully against other options for supporting small business activity. Most critical for the healthy expansion of commercial credit to small businesses are policies that offer greater protection to commercial creditors, most particularly the removal of current obstacles to the effective collateralisation of loans, as discussed in Chapter I. The severe liquidity constraints currently faced by Russian small businesses will only be alleviated gradually over time through the development of institutions for loan and other contract enforcement.

The 2001 OECD business survey asked entrepreneurs about effective means for enforcing contracts with business partners. The most common choice was “long-term business ties.” This confirms the continued predominance of infor-

Exhibit 5



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Chapter #: 7:

Chapter: INVESTMENT CLIMATE STATEMENT

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The Russian economy continues its first period of real growth since 1991, although growth rates in late 2000 and early 2001 have slowed down. Investment from both domestic and foreign investors is on the increase, although not growing as fast as was the case in late 1999 and early 2000. Despite some efforts by the Russian government to address persistent weaknesses in the investment climate, Russia remains a challenging environment for foreign investors. President Putin's government has shown a strong interest in attracting foreign investment and has promised to enact structural changes that would improve the environment for investors. However, most of these key steps have not yet been enacted.

Openness to Foreign Investment:

During Putin's tenure as president, the GOR has strongly stressed attracting foreign direct investment, particularly through structural reforms. While many regions have also developed laws and programs to attract FDI, there is increasing scrutiny of regional investment incentives. In practice, large investors continue to receive incentives. But these incentives are usually outbalanced by chronic severe shortcomings in the investment climate. High tax levels and extremely high costs in complying with Russian tax authorities, inconsistent government regulation, the inability of some investors to obtain redress through the legal system, and crime and corruption all dissuade investors. These systemic problems are abetted by chronically weak purchasing power, lack of financing sources, as well as concerns about long-term economic and political stability, which discourage investment.

The 1991 investment code guaranteed foreign investors rights equal to those enjoyed by Russian investors. This principle of national treatment was confirmed by the July 1999 law on foreign investment. The 1999 law includes a grandfather clause that theoretically protects certain large investments (over approximately USD 41 million) from unfavorable changes in tax or other legislation for a period of seven years. However, in practice, these protections have yet to be provided,

and gas sector privatization auctions, although some foreign firms participating appear to be affiliates of Russian companies. Foreign investors participating in Russian privatization sales often are confined to limited positions and face problems with minority shareholder rights and corporate governance. The treatment of foreign investment in new privatizations is likely to remain inconsistent. Roughly three-quarters of the Russian economy has been privatized, although many privatized enterprises continue to have significant state-held blocks of shares. Some privatization of remaining state holdings is scheduled to continue, both as part of overall government policy, and at local, regional and federal levels as governments seek additional cash. Some of these offerings may be considered good buys by some investors. Potential foreign investors are advised to work directly and closely with appropriate local, regional and federal officials that exercise ownership and other authority over companies whose shares they may want to acquire.

Despite a positive year for growth in 2000, unresolved structural economic problems, combined with real effective exchange rate appreciation that has dissipated the beneficial effects of the 1998 devaluation have kept massive new foreign investment away. Despite some recovery, still-low purchasing power continues to dampen the attractiveness of investments. Many U.S. companies here report recovery in their earnings, with some now back to or above pre-1998 levels. Russia's macroeconomic recovery has revived somewhat the attention of outside investors, although only a few new major projects have materialized. Overall U.S. exports to Russia grew by 25 percent in 2000 compared to 1999, but they remain significantly below levels of the mid-1990s. First quarter 2001 exports were still 43 percent down from the same period in 1998. The changed economic environment has made it more difficult for investment projects to qualify for financing, as few private western banks will accept Russian risk.

Rule of law, weak corporate governance and respect for property rights, although improved over the years, remains a key concern for foreign investors. Many large U.S. companies remain reluctant to pursue a strategy of growth through acquisition in Russia, because of fears of liabilities associated with existing operations (especially environmental cleanup liabilities), political pressures which would hinder economic restructuring, hidden financial liabilities, inadequate bankruptcy procedures, and weak protection of minority shareholder rights. In recognition of widespread corporate governance problems, the Federal Commission for the Securities Market plans to develop a corporate governance code by 2002, and some large private companies have developed their own voluntary corporate governance policies.

Accounting for about half of Russia's export revenues and comprising a major share of the world's undeveloped energy resources, Russia's oil and gas sector holds tremendous potential for foreign as well as domestic investment. After a long delay, new Production Sharing Agreement (PSA) legislation was adopted at the beginning of 1999 -- the State Duma finally approved remaining necessary legislative components of Russia's PSA framework, five years after the initial PSA law passed. By mid-2001, the Russian government had yet to complete drafting the roughly one dozen government administrative instructions ("normative acts") necessary to create a functioning regime in Russia. The

VAT refund system still does not function well.

In 2001, Russia moved to a flat individual income tax rate of only 13 percent for residents and 30 percent for non-residents, one of the lowest rates in the world. Deductions are allowed for, inter alia, home purchase or construction and exclusion of earnings on the sale of real property held for more than five years. The GOR's strategy is to substantially expand the current narrow tax base. In the first quarter of 2001, that strategy was successful, with both compliance rates and revenues up substantially.

Excise duties increased considerably, on oil and gas from R5 to R66 per ton; gasoline duties will rise from R585 to R1850 per ton. Excise taxes on natural gas exported to CIS countries will fall from the current 30 percent to 15 percent. The new law expands list of dutiable activities and objects, but several additional transactions became exempt, including exports performed by the producer of the goods (except oil).

Tax Reform Pending

Amendments to the Corporate Profits Tax law are now before the Duma. As of July 1, 2001, the Duma had passed these amendments in two of three required readings and the legislation is expected to be passed and signed by the President this summer. That version lowers corporate profits taxes to 24 percent and allows many more deductions than under current law, but does away with partial and full tax exemptions (including the capital investment exemption). If approved, the amendments would be effective January 1, 2002. Regions will be allowed to grant a 4 percent tax reduction.

There remains, however, a high incidence of tax avoidance by Russian companies, which has placed an even greater tax burden on foreign companies, with some complaints that foreign companies are more frequently targeted for tax inspections. Due process is relatively weak. Although foreign firms have successfully appealed to the courts, tax authorities have been slow to implement these decisions. Penalties for non-compliance include confiscation, and a company's accounts can be frozen relatively quickly. Tax authorities do not differentiate between criminal intent and honest mistakes when levying fines and penalties. The tax authorities currently do not have any organized administrative dispute procedures. As a result, companies often have little recourse other than the courts during tax disputes.

Value-added tax (VAT) rates are generally 20 percent, but a range of goods is taxed at 10 percent (largely foods, medicines, and some items for children). Both domestic and foreign companies exporting goods regularly complain that they are unable in practice to receive refunds of VAT for exported goods.

Efficient Capital Markets and Portfolio Investment

Although recovered substantially from the 1998 financial crisis, Russian equity

markets continue to be plagued by low trading volumes and a lack of liquidity for all but blue chip stocks. Approximately 70 percent of all stock trades take place off exchanges due, inter alia, to a desire by investors to avoid an issuance tax and disclosure of ownership.

Twelve stock exchanges operate on the Russian market. The dominant stock exchanges are in Moscow, the equity trading floor on the MICEX and the Moscow stock exchange (MSE). Equity trading on the OTC market is handled electronically by RTS and is patterned on NASDAQ with 270 users. Several Russian regional centers have their own stock exchanges, but trade volumes outside Moscow tend to be low. Regional exchanges are still dependent on Moscow-based participants

Government regulatory organizations, such as the Federal Commission on the Securities Market (FCSM) and, to a lesser extent, the Central Bank of Russia (CBR), are actively engaged in strengthening market infrastructure. A new joint stock company law was passed by the Duma in early 2000, but was amended by the Federation Council and it remains in an inter-parliamentary limbo. FCSM is also preparing voluntary corporate governance standards.

It is important for anyone looking at the corporate bond market in Russia to separate out "real" corporate bonds from bonds issued to tap into trapped S-account rubles. S-account bonds tap into the rubles trapped in S accounts at very low, even negative nominal interest rates. Gazprom, LUKoil, UES, TNK and some other companies have issued bonds specifically targeted at S-account holders. The attraction for buyers was that they could legally repatriate the proceeds from the bond. Generally, these bonds are long maturity, floating rate coupon bonds tied to the USD /R exchange rate.

Beyond S-account bonds, the corporate bond market is growing but still rather small. Corporate bonds can be traded on the MICEX trading system, but trading volume remains low. Part of the reason for the lack of trading is that most non-S Account bonds have coupon payments and puts exercisable on coupon payment dates, so there is little trading except just before coupon dates.

The banking sector remains one of the weakest legs in the Russian reform program, with little progress on systemic restructuring since the 1998 financial crisis. A fundamental lack of trust pervades the system: depositors do not trust banks, banks do not trust borrowers or each other, and no one trusts the Central Bank of Russia (CBR) to provide effective, impartial bank regulation. The result is that the Russian banking system largely fails to perform the basic role of financial intermediary, taking deposits and lending to business and individuals. Roughly 85 percent of retail deposits are held at the state savings bank Sberbank, while a majority of personal savings are presumably held as "mattress money." Lending to the real sector in Russia represents only 20 percent of GDP in Russia, vs. 50 percent in the US and 100 percent in Germany.

Bank capital is still only about 65 percent of its pre-crisis level in dollar terms. A lack of creditworthy borrowers, an inefficient legal system, and a lack of lending experience all contribute to systemic weakness. Mergers and acquisitions are

creating larger, more national banks. However, in the absence of effective regulation, it is difficult to say if this will add to banking stability.

The GOR remains deeply divided over the basic question of whether Russia's banking sector should develop toward a model centered on state banks or one centered on private commercial banks and thus is unlikely to implement any substantial reforms soon. CBR has yet to announce a clear strategy for the banking sector, which is necessary for reform on a commercial banking model to go forward. If state banks stay, it will be important that they face real competition from the commercial sector. Other issues that will need to be addressed include the CBR's conflict of interest as both bank owner and bank regulator, and the CBR ability to become an impartial and effective bank regulator. Legislative and regulatory changes also are needed for reform to go forward. The CBR needs greater regulatory authority, so that its interventions in failed banks can be swift and decisive. This would also require that bank owners face greater liability for bank failures.

Political Violence

Although the use of strong-arm tactics is not unknown in Russian commercial disputes, post is not aware of any cases where foreign investments have been attacked or damaged for political reasons. Russia continues to struggle with an ongoing insurgency in Chechnya, and the Chechen Republic and neighboring regions in the northern Caucasus have a high risk of violence and kidnapping. In addition, several bombings in major Russian cities may have links to this conflict, but there is no evidence that this sort of violence has been directed at foreign investments or installations.

Crime and Corruption

Crime has become one of the most frequently cited concerns of foreign (and Russian) businesses, particularly those involved with large amounts of cash and goods. While organized crime is not new to Russia, the past decade has seen an increase in the range and frequency of criminal activity. Unfortunately, legal and judicial reforms have not kept pace with criminal advances. Much crime is tied to commercial activity, with many Russian entrepreneurs in a survey reporting that they must pay kickbacks and protection to stay in business. Crime statistics for 2000 show moderate decreases overall in reported crimes, with the exception of increases for drug offenses.

U.S. firms have identified corruption as a pervasive problem, both in number of instances and in the size of bribes sought. Successive Russian governments have designated the fight against corruption as a priority task of government due to its economic costs (particularly the deterring of foreign and domestic investment and encouragement of capital flight). President Putin has repeatedly stressed that enforcement of laws is a high priority of his administration, and has periodically focused attention on corrupt practices. Russia has laws and regulations against bribery and other forms of corruption, but penalties are often

Exhibit 6

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FINANCE & ECONOMICS**Russian bank reform****Don't bank on it**

Oct 18th 2001 | MOSCOW
From The Economist print edition

Russia's latest banking reforms don't go deep enough

JUDGED by the number of laws passed, it all looks rather promising. Reforms so far this year, on banking supervision, accountability and money laundering, mean that Russia's 1,300-odd banks have never had a tougher, clearer set of rules to work by. Impending changes will aim to attract more foreign banks, set up proper licensing requirements and increase depositors' protection.

So far, so good. But as with all Russian economic reforms, what the law says is one thing; how it is applied by bureaucrats, notably in the provinces, is another. Russia still lacks a corps of financial administrators who could properly handle a single insolvent bank, let alone a bunch of them.



Gerashchenko's guarantee

A second, huge problem is that the reforms leave untouched the biggest distorting influence in the whole system: the central bank. This imposes a regulatory burden verging on the preposterous. Practically every transaction must be recorded on paper (not electronically). Silly rules mean that even respectable banks have to park their assets offshore. The cost of all this is one reason why foreign banks are so reluctant to increase their activities in Russia.

These rules are also unfairly applied. Banks with good political connections obtain lucrative favours and exemptions. Outsiders risk penalties for missing a comma. The self-satisfied atmosphere at the central bank hardly corresponds to the puny system it runs.

The central bank is a big operator in the industry it itself supervises, particularly through Sberbank, the biggest in the country, in which it has a 61% stake. Scalded by past crookedness, Russian savers do not trust banks much. When they do, Sberbank's de facto deposit guarantee makes it the obvious choice. That pool of cash gives it a huge competitive edge. Private-sector rivals complain that it lends at negative interest rates.

So far the central bank, ensconced in luxurious buildings in Moscow and in regional outposts across Russia, has beaten off attempts at reform. The governor, Viktor Gerashchenko, a veteran of the Soviet banking system, has kept politicians sweet by deftly using his bank's patronage. "The biggest reform Russia needs is at the central bank," says Boris Fedorov, an independent director of Sberbank and former finance minister. Yet even with the right reforms, and the right central-bank boss, it is an open question whether a healthy banking system can develop in such murky waters. Kim Iskyan, author of a new study on the Russian banking system, believes that, as things stand, another banking crisis—with all that will

do to confidence—is only a matter of time.

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Exhibit 7

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HEADLINE: The Building Blocks of Bank Sector Reform

BYLINE: By Torrey Clark

BODY:

Staff Writer

Three years after the 1998 financial crisis brought down nearly a dozen of the country's mightiest banks, the government and the Central Bank have approved a reform plan for the sector. It touches on areas of utmost importance: capital growth, competition, privatization and Central Bank reform. But is it enough? The new banking plan reflects two opposing lines of thought on banking reform that have prevailed since the meltdown.

One - touted by the Central Bank itself - is that a strong banking sector will develop only when economic and legal conditions are ripe, and that radical steps could destabilize the system.

The other is that the Central Bank's lack of forceful action has resulted in a system that is clogged with undercapitalized, shadowy institutions whose purpose is to manage cash flows rather than intermediate, that is take in savings and lend them to the real sector, and skewed by the actions of **state -owned banks** with noncompetitive advantages. "Mistakes made as a result of taking action are more easily recognizable and quantifiable than the mistake of not taking action," said Vladimir Rashevsky, deputy chairman of MDM-Bank.

The plan, signed by Central Bank chief Viktor Gerashchenko and Prime Minister Mikhail Kasyanov in December, is a compromise between the two lines of thought.

Its very existence is evidence the government has chosen an active route, but vague wording and a medium- to long-term time frame raise doubts whether tangible steps will be made in 2002. It signals some willingness on the government's part to take on the Central Bank, but not until a decision on Central Bank leadership is made. Gerashchenko's term is due to end this year.

The Central Bank wields considerable power both as a regulator and a participant in the financial sector, while answering to no one. This creates conflicts of interest and lays the foundation for rampant corruption, corporate governance advocate Dmitry Vasilyev wrote in a joint report with the Moscow Carnegie Center. Efforts to amend the Central Bank law giving supervisory powers to the National Banking Council, dominated by government and State Duma representatives, were delayed again last Friday, with the Central Bank vowing to defeat them outright.

Capitalization and Consolidation In an attempt to pump up the sector, a minimum capital requirement, at a ruble equivalent of 5 million euros, is to be imposed on all banks starting in 2007. The idea is that forcing banks to increase their capital through growth or consolidation will improve their ability to lend.

If enforced, it will also weed out hundreds of tiny banks, narrowing the target of the Central Bank's supervisory energies.

Capital levels do not, however, guarantee stability, as the Central Bank has argued and experience has demonstrated. The 1998 devaluation and government default on domestic debt felled primarily the largest banks.

A better measure of stability is the capital adequacy ratio, which compares a bank's capital to its assets, such as **loans** and investments in securities. The required ratio is to be increased from 8 percent to 10 percent for banks with less than 5 million euros in capital starting in 2005 and for all banks in 2007.

"As an economy turns south and capital becomes more precious, banks have to generate more capital or lend less, so the capital ratio remains above minimum standards. It forces discipline in the system," said Barry Eden, partner in charge of the financial services industry at Ernst & Young. "According to our research, emerging markets would be better off going towards a 12 percent ratio." "Banks are much stronger over their cost base and their risk management, but they are not more stable because their capital barely keeps up with their assets," said Richard Hainsworth, head of bank rating agency RusRating.

The plan sets out other measures to enhance lending, such as amending the civil code to allow credit history agencies to be set up and to create a mortgage securities market. Economic incentives and legal protection also play a key role.

"The problem is not the banks, it is the economy," said Hainsworth. "Lending requires an assurance that assets transferred or pledged to another party can be secured in the event of default, while maturity transformation, that is, borrowing short and lending long, requires stability over time. In their absence, there is little incentive to build up massive asset bases or to secure them with capital," Hainsworth said.

Transparency The introduction of international accounting standards in 2004 is expected to improve the overall transparency and the understanding of risk in a sector notorious for opacity.

"Russian accounting standards are built on form over substance," Eden said. "A transaction or ownership can be structured so that underlying meaning is unclear. The result is that people putting money into a bank, depositors and investors, may have much more at risk than it would appear on the surface." The Central Bank pushed for a 2004 deadline on the ground that "many commercial banks would experience serious difficulties," if IAS were introduced more quickly. In the meantime, the Central Bank, which looks at RAS data, is limited in its understanding of the true risk or potential insolvency of the banks it is supposed to regulate.

"Most serious banks, banks that can be called banks, have long since introduced IAS. They will have no trouble," said Rashevsky.

IAS in itself does not ensure transparency. Until banks themselves find that greater transparency is in their best financial interests, they may continue to play hide-and-seek with the Central Bank and auditors.

Improving Competition Sberbank's monopoly in the retail market - it holds about 75 percent of all deposits - has been aided by an exclusive government guarantee and acts as a major barrier to development of true intermediation in the market.

Deposit insurance is to be introduced on a voluntary basis after legislation is developed this year. After IAS is introduced, it will become mandatory. The goal of such insurance is to increase the population's trust in commercial banks, attracting more and longer-term savings into the sector and increasing banks' ability to lend.

"Clients' confidence remains very low, so banks' resources remain insignificant compared to the huge level required by the economy," said Michel Perhirin, board chairman of Raiffeisenbank in **Russia**.

Designed to increase competition for retail deposits in a market dominated by Sberbank, the deposit insurance program will need more than IAS to neutralize potential moral hazards such as when banks take unfounded risks, knowing their deposits are guaranteed, or the population puts money in a risky bank offering high interest rates, trusting the guarantee to save them if their bank goes under.

The measure is one step toward leveling the playing field between private banks and mammoth Sberbank.

Privatization Another step toward a level playing field is privatization. **State-owned banks** have less incentive to act as profit-oriented commercial enterprises than to lend to state-owned or affiliated companies at lower rates than private banks can afford.

"The country's two largest banks, Sberbank and Vneshtorgbank, belong to the Central Bank, which may allow them access to cheaper money than other banks. They can lend at lower rates, which skews the sector," said Kim Iskyan, banking analyst at Renaissance Capital.

The bank reform plan pledges the government will look at selling its stakes of less than 25 percent in more than 400 banks, but allows the government to keep stakes of more than 25 percent in "strategically important" banks.

Two years after President Vladimir Putin ordered an inventory and analysis of all banks with state capital, a joint Finance Ministry and Economic Development and Trade Ministry commission published its results. The commission found that "in most cases, federal authorities exercise no control over the state's property," reported the Vedomosti daily. Only seven tiny banks out of 40 banks with more than 25 percent state ownership have been tagged for sale.

Vneshekonombank, which services **Russia's** foreign debt, is to have its commercial function split off to create a new bank, but no mention is made of privatizing it, despite the government's promise not to open any new state banks.

The Central Bank is permitted to own Sberbank "for the next several years," although the plan shifts some control of the retail monopoly to the government. A plan to transfer Sberbank to the government is to be developed after Sberbank fully participates in the deposit insurance program.

A controlling interest in Vneshtorgbank - once the Central Bank agrees to transfer its stake to the government - may also sit on the government's balance sheet indefinitely. The government plans to keep a stake that will allow it "to influence the bank's policies." It is not yet clear when or how the government will acquire the controlling stake in Vneshtorgbank from the Central Bank. The banking reform plan sets Jan. 1, 2003, a clearly unrealistic target date, for the Central Bank divestiture.

"Regarding the full divestiture of the Central Bank by 2003, I wouldn't say that it is a complete fantasy, but ... let's just say that one document discussed a 'preliminary reference date' of Jan. 1, 2003," said Vneshtorgbank chairman Yuri Ponomarev at a news conference Friday.

The battle between the Central Bank and the government for control highlights a significant weakness in the reform process.

"There is a danger that the entire banking reform process could become a political football, and the economy can't afford that," said Iskyan of Renaissance Capital.

Foreign Participation The possible sale of a stake in Vneshtorgbank to the European Bank for Reconstruction and Development is a positive signal that the government and Central Bank are willing to open the sector to foreigners. Foreign involvement is seen as a means to increase bank capitalization and improve behavior standards.

To attract investment, the plan promises to give foreign banks treatment on par with domestic banks. Foreign banks are to gain the right to purchase stakes of less than 10 percent in domestic banks without applying for the Central Bank's permission and more than 10 percent with permission. It also states the Central Bank will not formally introduce foreign capital limits in the sector.

Central Bank Reform Having a signed plan and government commitment are positive signals. However, the success of the banking sector development plan depends not only on drafting and passing a raft of new laws and regulations, but also on the regulatory body's ability and willingness to enforce them.

With 65,000 employees and 78 territorial administrations, the Central Bank is bloated. "It needs to be cut down and streamlined," RusRating's Hainsworth said. "They spend more time on bureaucracy than on analyzing banks." The government has begun to chip away at the Central Bank's monolithic power, by pushing the bank reform agenda, creating the Financial Monitoring Commission to keep an eye on international transactions and shifting control of Sberbank and Vneshtorgbank.

The bank reform strategy, even if fully implemented, cannot cure all of the system's ills. But action is encouraging.

Top 10 Banks by Capital Bank Capital* 1 Sberbank 60,283,555 2 Vneshtorgbank 45,215,336 3 Mezhdunarodny Promyshlenny Bank 27,180,146 4 Alfa Bank 22,788,881 5 Gazprombank 16,576,730 6 Globex 10,123,821 7 Rosbank 7,101,117 8 Rossiisky Bank Razvitiya 4,849,465 9 Bank of Moscow 4,626,079 10 Mezhdunarodny Moskovsky Bank 4,489,650 * In thousands of rubles, as of Oct. 1, 2001 (rate: 29.39 rubles to the dollar) Source: Rating Information Center
Top 10 Banks by Assets Bank Assets* 1 Sberbank 771,462,321 2 Vneshtorgbank 146,497,845 3 Gazprombank 104,253,079 4 Mezhdunarodny Promyshlenny Bank 101,098,286 5 Alfa Bank 100,744,968 6 Mezhdunarodny Moskovsky Bank 87,484,979 7 Surgutneftegazbank 78,127,916 8 Bank of Moscow 59,167,207 9 Rosbank 51,318,856 10 Doveritelny I Investitsionny Bank 49,527,242 * In thousands of rubles, as of Oct. 1, 2001 (rate: 29.39 rubles to the dollar) Source: Rating Information Center
Top 10 Banks by Profit Bank Profit* 1 Sberbank 17,711,843 2 Vneshtorgbank 5,423,503 3 Citibank 1,798,237 4 Doveritelny I Investitsionny Bank 1,497,157 5 Promyshlenno-Stroitelny Bank 1,164,190 6 Alfa Bank 980,642 7 Gazprombank 795,175 8 Rosbank 770,289 9 ABN Amro 727,807 10 Mezhdunarodny Moskovsky Bank 591,253 * In thousands of rubles, as of Oct. 1, 2001 (rate: 29.39 rubles to the dollar) Source: Rating Information Center

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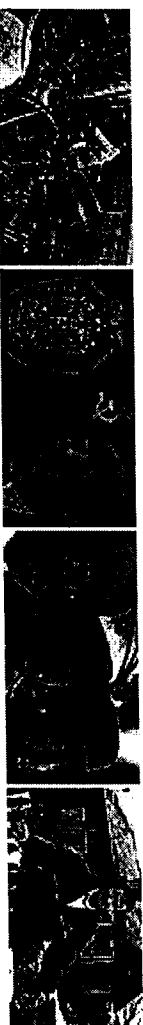




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The "unjustified usage" of foreign

Don't Give Money to the Banks! (Kommersant)

The Anti-Monopoly Ministry strikes out at Russia's banks

by Natalia Kulakova
issued on 27.03.02

[printable version]

On March 26 the Anti-Monopoly Ministry lambasted nearly every player on the stock market and spearheaded its attack against banks, saying 80% of them were "pocket" banks serving only their own stockholders. It also offered an original method of dealing with the situation: it said the rights of the banks' owners should be curtailed. Those of them who owned more than 25% of a bank's assets should no longer be allowed to keep money in it. The ministry promised to draft relevant amendments to the Civil Code by July.

This would, in effect, be the most thoroughgoing re-division of the banking market in its history. Government institutions with accounts in state-owned banks will also take part in the re-division.

The ministry explained its revolutionary proposal in the following way:

expressions may be prohibited (Vremya MN)

- **As Had Been Expected**
The victorious Media-Sotsum will make decisions unanimously (Vedomosti)

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- **Supreme Court Reinstates Military Secret Decree**
Russian military has urged the Supreme Court to validate the controversial decree on military secrets (Gazeta.ru)

- **Putin Is Getting Tedious**
The latest national public opinion poll shows that Russians are gradually becoming disappointed with their president, his team and his policies (Gazeta.ru)

- **Russian Troops to Stay in Georgia**
The Russian defense minister links the planned withdrawal of Russian troops from Georgia to the settlement of the Abkhazian conflict and the presence of U.S. troops in Georgia (Gazeta.ru)

- **Russia to Boost Vietnam Ties Despite Pullout**
Prime Minister Kasyanov and his Vietnamese counterpart will discuss ways to expand bilateral trade from \$571 million (2001) to more than \$1 billion (Gazeta.ru)

- **Russian General Held Hostage with Shevardnadze's Knowledge**
Georgia's former defense minister admits that Shevardnadze knew that Russian General Shpigun was being held in the Pankisi Gorge (Lenta.ru)

- **Russian "Noisy" Planes Allowed in Europe**
Russia and Europe appear to have avoided the air war over Russian "noisy" jets (NTV.ru)

- **Former KGB General Sees Putin Behind Treason Charges**

according to available information available, some 80% of the banks serve only their stockholders, but even if they also serve other clients, the quality of service is much lower. It singled out "diminished scope for the diversification of capital, making for greater banking risks" as the main problem, adding that this impeded the development of the banking system.

Original text

Author(s): Natalia Kulakova,
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THE RUSSIA JOURNAL

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News & Analysis Weekly

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INVESTMENTS IN RUSSIA: Russia's investment climate: problems and prospects

By VLADIMIR KREINDEL, Special for Investments in Russia

Judging by comparative studies conducted for a number of countries, short-term forecasts for the Russian economy give no grounds for optimism. In 2001, Russia ranked 79th out of a total of 91 countries on Transparency International's corruption-exposure rating list. The American Republican think tank Heritage Foundation placed Russia at 131st place out of a total of 153 on its economic-freedom index rating as of 2002. Experts from the World Economic Forum give Russia 63rd place out of 75 in terms of economic-growth potential and 58th out of 75 in terms of competitiveness. Therefore, there are no reasons to expect any significant increase in the volume of foreign investment in Russia's economy. It is worth recalling here that successes in economic reforms in many countries that once belonged to the orbit of the former Soviet Union, like Hungary and Poland, occurred precisely as a result of sizable direct investments from foreign companies.

Direct foreign investments are particularly important for transitional economies that cannot accumulate owned funds in sufficient amounts to implement modernization and innovation projects. Per capita volume of direct foreign investment in Russia is as low as \$1.98 (according to estimates made by the Heritage Foundation for 2002), far behind those of other emerging markets. For comparison, in Hungary the figure is \$92.7. There are many reasons for this pitiful situation, including the high rate of corruption, imperfection of tax legislation, lack of clarity in the sphere of property rights, an inefficient judicial system, inconsistent economic policy and high inflation. ✓

✓ The State Statistics Committee reports that the total volume of direct foreign investment in the Russian economy currently equals \$5 billion, and the inflow of such investment is extremely low. According to government estimates, the country needs at least \$100 billion every year just to maintain equipment rotation, while it actually gets only 1,575 billion rubles (approx. \$55 billion).

✓ There is no common opinion in the Russian Ministry of Economic Development and Trade. The head of the Ministry's Department for Investment Policies, Sergei Bayev, insists that twice the present rate of investment is required just to maintain production at its present level, while the Ministry's head, German Gref, promises 4-5 percent economic growth.

Who is right, and what should the government do about the situation? Active government measures to stimulate production may result in misuse of government funds. Creating favorable conditions for specific economic sectors is also fraught with dangerous possibilities (suffice it to recall the recent sad experience of establishing free economic zones).

✓ The answer to the question is very simple, though the problem will hardly be resolved any time soon. All that needs to be done is create a normal competition environment in the Russian economy. Only after that will it be possible to expect increase in the rate of investment.

✓ As things stand today, investments are concentrated mostly in the monopolized sectors, primarily in the oil and gas industry. The fuel and energy sector accounts for 53.3 percent of total investment in Russian industries, including 34.8 percent in oil production. According to the State Statistics Committee, 3,333 oilrigs were put into operation during January through October 2001, up 23 percent from the corresponding figure for the year 2000.

The following industries have prospects of becoming attractive for both domestic and foreign investors

in the near future: electricity, retail trade, agriculture and insurance. Though a lot of ink has been spilled about the need to develop high-tech industries and cutting-edge technologies, very few companies and enterprises in this sector have succeeded in attracting investment.

The government's economic policy is oriented toward fulfilling the correct recommendations made by international consultants, or at least this is what the authorities are declaring. It would be much better if the declared processes of de-bureaucratization, reducing the tax burden and restraining inflation were going on a bit faster. So far, there have been lots of reorganizations and discussions and many draft laws have been enacted, but they have not produced any noticeable effect on the actual situation in the industries.

Another factor reducing Russia's investment attraction is the unwillingness of company owners to hire managerial teams from outside, even if this would give access to new technology and other valuable opportunities. There are only a few exceptions in a limited number of industries, for example in telecommunications, where the presence of foreign capital and foreign managers is fairly strong.

A diametrically opposite opinion on foreign investment in the Russian economy exists. Presidential adviser on economic issues Andrei Illarionov maintains that foreign investment is only harmful for the Russian economy. Alternatively, the chairman of the board at the oil company Yukos, Mikhail Khodorkovsky, has proposed to drastically reduce taxes in order to release funds for investing. It must be noted here that an economic model where investments are generated by "wealthy sectors," be it the oil industry or others, is fraught with the formation of a Korean-like "clustered system" that may have a negative influence on both economic and political processes.

Instead of stimulating the formation of behemoth-sized holdings, it is necessary to take consistent measures to improve the investment climate in the country, thus attracting both domestic and foreign investors. To achieve that, there is no need to set up yet another "council on investment," but to implement reforms to reduce the government's excessive presence in the economy. It will not be possible to attract any substantial volume of investments without resolving the problem of corruption, improving tax legislation and making the judicial system more effective. We obviously must conclude that Russia will not see any investment boom before the government starts implementing its planned reforms. Therefore, for the next three to four years, the Russian economy will have to count mostly on its available material, human and technological resources.

(The author is staff researcher at the Institute of Financial Research)

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Exhibit 10

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Unclassified



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Entry Date: 03/20/2002

Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: DOMESTIC ECONOMIC****Source-Date: 03/20/2002****Russian Economist Denies Reports of Financial Crisis***CEP20020320000346 Moscow Vedomosti in Russian 20 Mar 02*

[Article by Yevsey Gurvich, scientific supervisor of Economic Advisory Group: "Firing at False Targets" – taken from HTML version of source provided by ISP]

[FBIS Translated Text]

Once again, journalists and economists have been quick to use the drop in current indicators as an excuse to announce a financial crisis, a recession, or an ominously rising rate of inflation. This is always followed by frenzied discussions of emergency solutions. After this, however, the situation stabilizes, growth resumes, and the crisis is postponed. The latest data indicate that the same thing is happening again: After a few months of reduction in the industrial product, output increased in February (allowing for seasonal and calendar factors) to almost its previous level.

Problems and Pseudo-Problems

In fact, there is no objective reason to anticipate a recession or crisis in Russia in the near future. We have made tremendous progress in recent years: We have a budget surplus instead of the deficit, equivalent to more than 5 percent of the GDP, we had ever since 1998. The economy has ceased to be based on barter and debts, and more and more activity is emerging gradually from the shadow sector. We have a huge foreign trade surplus, the capital drain is dwindling, the real exchange rate has stabilized, inflation is still moderate and predictable, and our debt burden is growing lighter. These certainly are not signs of imminent crisis. The country has acquired sufficient momentum in the post-crisis years, and the state and private sectors have accumulated substantial reserves. Economists are surprisingly unanimous in their predictions for 2002: Most of their estimates of GDP growth fall within the range of 3-4 percent, and they agree that inflation will be about 14-16 percent.

This certainly does not mean that we have nothing to worry about, or that steady growth in the foreseeable future is guaranteed. Our short-term stability has been accompanied by the gradual decline of annual growth rates. Investment is growing, but it has not displayed any qualitative improvement: The innovative activity of businesses is still negligible. Numerous long-term problems are the cause of this. Some are just beginning to be solved, and no one is even attempting to solve the others yet.

We have a good chance of remaining a country with a raw material economy. Most of our profits are concentrated in raw material exports. If our financial mediating system remains weak, and if investors remain completely unprotected, we can safely assume that the processing sector will be unable to attract sizable capital investments and will be doomed to deterioration. The urgently needed restructuring of the financial system is progressing so slowly that one might think we needed only a light coat of polish.

In other countries with a transitional economy, development takes place primarily in the dynamic sector of new enterprises. Small business here has been stifled by taxes and other fees and by the tyranny of local officials. Acknowledging this problem, the government pushed the notorious package of deregulation bills through the Duma. Before they can work, however, one more "minor" adjustment has to be made: The very bases of public administration have to be changed throughout the country.

Strong state institutions are an essential element of successful economic development. They must guarantee the safety of the individual and the safety of business, secure the effective work of the judicial system and the enforcement of legal decisions, and stimulate new business. Recent World Bank studies indicate that the quality of Russia's state institutions gives the country no chance of moving up to a higher income level.

The government responds quickly to isolated dips in economic indicators. In an attempt to curb inflation and support production growth, government officials recently limited the already announced rate hikes of the natural monopolies, and now they seem to be considering Andrey Illarionov's recommendations regarding the weak-ruble policy. Cheap energy and a cheap ruble essentially have the same effect on the economy: They facilitate the Russian producer's competition with foreign producers. Is this the right move, however?

Dangerous Inequities

The successful development of our economy ultimately requires incentives for heightened effectiveness and investment. The problem is that both are distributed quite unevenly in the economy. If competition is weak, an enterprise has no incentive to enhance effectiveness, and if competition is strong, it has no chance of doing this. Raw material sectors are not feeling enough pressure, and the processing branches are having increasing difficulty competing with imports.

The accessibility of investments is just as variable. The extractive branches have surplus capital of their own (the capital drain from these branches is a clear indication of this) and access to the capital market. The processing industry, on the other hand, is experiencing an acute shortage of resources. Are these differences due to the more successful work of the raw material sector? No. They are due exclusively to the substantial amount of natural profits remaining in the raw material sector: both direct profits, resulting from the distorted tax system, and indirect profits, derived from the use of cheap energy.

Maintaining or raising the current level of protection against foreign competition would keep the raw material companies "on easy street" and widen the gap between them and the sectors with high added value. This policy will support growth for a short time, but it has absolutely no long-term benefits. It eventually will perpetuate the raw-material bias of the economy (other sectors will simply lack the resources required for modernization) and reduce growth rates to 2-3 percent a year, which will cause us to lag further behind the world's leading countries.

It is time to stop the vigorous fight against imaginary threats and begin solving strategic problems. The aim of economic policy should not be the protection of domestic producers from competition, but the equalization of levels of competitive pressure (while gradually increasing this pressure) and the elimination of sectorial differences in the return on investments, stemming from the low cost of natural resources. This can be achieved by a combination of the following measures.

The appropriation of a larger share of natural profits for the budget and the alleviation of the tax load in the processing sector. Last year's presidential message to the Federal Assembly proposed the equitable taxation of natural resources by lowering taxes not related to natural profits. No action was taken on this idea, however.

Higher gas and electricity prices (but not for the "automatic" satisfaction of monopolist appetites). The simultaneous regulation of prices and taxes in the gas industry can produce any combination of consumer and supplier prices.

The establishment of a healthier banking system and the development of other segments of the financial mediating system (the corporate bond market, private pension funds, etc.).

Planning Horizons

These measures (along with the reinforcement of state institutions) can turn the Russian economy into a competitive entity and secure its steady growth. Their short-term effects on growth indicators might seem negative (although we do not expect them to be too strong), but the establishment of the necessary incentives and conditions for the long-term development of all sectors will more than make up for this. In fact, even the positive impact of Russia's accession to the WTO should be linked less with quick and easy access to foreign markets for our goods than with the gradual and controllable intensification of competition in the foreign market.

The warnings about an imaginary crisis that could strike at any time are harmful because they divert attention from basic problems, or simply interfere with the resolution of these problems, which will determine the Russian economy's course of development and its chances of development in general. If we keep focusing on transitory threats, we will never have time for strategic priorities. If we keep concentrating on our present position and keep making mountains out of molehills, we will never find time to look ahead and start working on the things that actually will decide our future.

[Description of Source: Moscow Vedomosti in Russian -- Business paper published jointly with The Wall Street Journal and Financial Times; reportedly friendly with Kremlin.]

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Exhibit 11

THE RUSSIA JOURNAL

www.russiajournal.com News & Analysis Weekly

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TELECOMS RUSSIA: Telecoms cry for investments

By ANATOLY TKACHENKO / Special to Telecoms Russia

Though both government structures and corporate heads are trying hard to boost the investment attraction of the telecom sector, the situation remains critical and the shortage of capital is aggravating.

Stock market

Last year's situation in the market for telecom shares graphically demonstrated that the period of "investing in the sector" had ended, leaving in its place a period of "investing in the company," i.e., when investors carefully select a specific company to put their money into.

Money is coming into specific telecom projects mainly in the cases of mergers or takeovers, and no substantial primary share placements are taking place on the Russian exchanges today, just like in 1997. To raise the cash needed for development, Russia's telecoms prefer to enter the Western capital market, particularly through placing ADRs, but only a few companies can afford to do that. Those who cannot enter the Western capital market prefer to raise cash by placing bonds on the domestic market. Thus, Moscow City Telephone Network (MGTS) has placed ruble bonds of a total of 600 million rubles and is currently placing a second bond issue totaling 1 billion rubles. Another wire-line operator, CenterTelecom, has placed ruble bonds totaling 600 million rubles. Meanwhile, regional telecoms are preparing to follow suit.

"The increased activity on the part of investors and speculators and their new tactics give reason to conclude that Russia's investment climate and the situation on the Russian stock market have drastically changed for the better," said William Kimm, Ernst & Young's executive director. Later, Kimm named the following positive trends on the Russian stock market: spread narrowing, increased acquisitions of foreign corporate shares by Russian companies, increased investment activity on the part of the owners of large Russian companies and the replacement of speculators by serious long-term investors.

Svyazinvest and other wire-line telecom operators

For a long time, the 25 percent stake in Svyazinvest was viewed as a tidbit by a number of internationally famous companies that competed with each other in efforts to get a bigger slice of the Russian telecom pie. But as the years passed, the value of the stake (which was acquired by the offshore Cyprus-based company Mustcom) fell 82 percent, from \$1.9 billion to \$342 million. A similarly sad fate befell many regional telecoms in Russia. For example, the market values of the stakes in Artelecom and Republic Karelia Elektrosvyaz, which were acquired by AIG Brunswick for \$27.1 million and \$14.5 million, respectively, plummeted down to \$5.2 million and \$3.5 million. Similar or nearly similar depreciation has been suffered by the shares of Svyazinvest's other regional outlets that were acquired by foreign investors.

Now, Svyazinvest is determined to make a dramatic increase in capital investments. Over the next four years, the holding plans to invest more than 110 billion rubles in its facilities, and more than 55 of it will go into local communication networks. Major attention is being given to consolidating Svyazinvest's regional outlets by merging them together into bigger companies, which is expected to boost their investment attractiveness. The fact is that most investors will not put their money in a telecom with a capacity of under 400,000 access lines. When commenting on these plans, analysts from various investment companies said the planned mergers are likely to boost market capitalization.

According to the analysts, the market value of Povolzhie Telecom will increase by at least 20-25 percent, i.e., from the current \$270 million to \$330 million to \$340 million.

Meanwhile, the alternative (not belonging to Svyazinvest) wire-line operators of Moscow and St. Petersburg have rushed to expand into the regions, as they have exhausted all possibilities of growth in their existing markets. They are seeking to establish their presence in the regions before Svyazinvest completes its reorganization plans. After all, if Svyazinvest succeeds, competition in the regional markets will be much tougher.

The situation that has formed on the regional wire-line telecom market particularly benefits the domestic financial-industrial groups. Having made money on the raw-materials markets, mostly the oil market, they tend to view telecoms as the most attractive object for investing. Confirming the growing interest of Russian financial-industrial groups in wire-line communications is the recent acquisition by the Menatep Group of all telecom assets of Andrew Corp. (United States) for a total of \$110 million.

Cellular communications

If it is not quite clear at the moment whether the wire-line operators will see a boom of investments or not, there is practically no doubt about the mobile-telecom sector. It is obvious that mobile telecoms, as well as integrated-service providers and broad-band networks, represent a sector into which investors are willing and eager to put their money without any second thoughts. The main factors determining the sector's high investment attraction are its high tempo of growth, absence of tariff regulation and the high quality of corporate management.

Back in the mid-1990s, investors made their choices guided by such criteria as a company's size, number of clients and number of access lines, but now they are more interested in a company's financial standing, profitability, quality of management, respect for shareholder rights and development dynamics. In 1999, Telenor acquired a 25 percent stake in VimpelCom for \$162 million and invested another \$52 million later in order to keep its right to a veto at shareholder meetings. Later, in 2000-01, Telia bought a 25 percent stake in Telecominvest for \$102 million.

In the next three years, the three biggest mobile telecoms – Mobile TeleSystems (MTS), VimpelCom and Megafon – plan to put a combined total of \$1.8 billion into the development of the regional networks, increasing capacities and improving coverage.

An important event on the mobile telecom segment was the acquisition of a large VimpelCom stake by Alfa Group for \$130 million in 2001. Again, this proves the existence of a strong interest on the part of Russia's financial-industrial groups in the mobile-telecom sector.

Not long ago, battles for control over Russian mobile telecoms involved mostly foreign investors (Scandinavian for Vimpelcom and Telecominvest, and German for MTS), and now Russian financial groups have entered the arena. It is worth noting that Russian financial groups have an advantage because they are better adapted to the local market's conditions and have ways to influence the situation in the regions.

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Exhibit 12

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Report wary on future of Russia's IT sector

By VLADIMIR KOZLOV / The Russia Journal

Russia's chance of emerging as a major IT nation will primarily depend on its ability to attract venture capital and develop sufficient business culture, as well as on the government's support for the sector, according to a report on Russian technology prepared by Brunswick UBS Warburg.

"Russia presents a win-or-lose case – either it manages to tap into the global tech market (through offshore programming or selling ... end products and technologies), even in the currently tough global environment, or it remains stuck within its national ... borders," said the report published earlier this month.

According to Brunswick UBS Warburg, Russia has a remarkable intellectual resource pool for the IT industry and, despite the brain drain of the early 1990s, it remains a world leader when it comes to its large number of engineering and science personnel. With 55 engineers per 10,000 people, Russia ranks behind Israel, the United States and Japan, but is considerably ahead of India, said the report.

But despite its academic and professional resources, Russia's IT sector faces considerable difficulties adopting reasonable business strategies aimed at increasing profitability and market capitalization, said the report. "The main reason Russia's vast intellectual capital is underutilized is the generally underdeveloped level of business culture in the Russian technology sector."

The report's authors point out that many traditional businesses in Russia have gone several steps further in adopting new business processes to help them improve efficiency than companies in Russia's IT sector. "While brick-and-mortar companies – through fair or unfair competition – have generally evolved over the past five years to the point where the focus is on maximizing profits, many IT entrepreneurs still concentrate more on personal recognition, whether monetarized or not."

✓ According to the report, Russia's IT sector is also suffering from a lack of venture capital, with just over \$100 million invested in the industry so far, compared with about \$300 million in India last year alone.

The report's authors note that the lack of foreign venture capital in the Russian IT sector results from poor business culture in the sector, which provides for mismanagement and extensive coaching of investment projects.

Meanwhile, the government has not yet provided initial support for the IT industry either, according to the report. "Justifiably or not, development of the IT sector has so far not been on the government's list of priorities."

The report mentions several projects sponsored by the Russian government in the IT sector, including the \$2.5 billion "Electronic Russia" scheme, aimed at the promotion of IT for business processes. Also mentioned were a \$1.9 billion program of providing educational institutions with computers and Internet access and a program to support the domestic software industry.

"We consider [these projects] plausible, but are taking a cautious approach as plans laid out by the government may not materialize in their initially planned form, or may benefit individual companies and state bodies, rather than create an equally favorable environment for the industry as a whole," the report said.

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Exhibit 13

#5

Wall Street Journal

August 3, 2001

[for personal use only]

U.S. Company Loses Control Of Quartz Glass Plant in Russia

By GUY CHAZAN

Staff Reporter of THE WALL STREET JOURNAL

MOSCOW -- In a case that highlights the pitfalls of doing business in Russia, a U.S. firm has lost control of a Russian quartz glass factory in which it had invested \$7 million (7.9 million euros).

On Tuesday, a Russian federal court threw out an appeal by Sawyer Research Products Inc., an Eastlake, Ohio-based producer of electronic grade quartz, against the takeover of its facilities at a quartz factory in Gus-Khrustalny, a small town north of Moscow. The takeover was instigated by two rival Russian firms, ROEL and Vladimirtechnoservice, which are also Sawyer's creditors.

"This is expropriation, pure and simple," said Dmitry Vasiliev, chairman of Russia's Investor's Protection Association. "Two Russian businesses with links to the local administration have seized the property of an American company. It's a very bad precedent, which shows the weakness of the Russian courts."

Sawyer Chief Executive Gary Johnson said the company would be "forced to obtain protection of its rights in an international tribunal," possibly the European Court of Human Rights in Strasbourg, if Tuesday's decision is allowed to stand. "We can't get into the plant, our inventory has been seized and is now being sold off," he said.

Sawyer is just the latest in a long list of foreign investors to fall foul of Russia's court system, widely seen as post-Soviet Russia's least reformed institution. Campaigners for legal reform say some judges are susceptible to pressure from local government officials and powerful business interests that use them to attack competitors. Investors routinely complain that contracts and property rights are often impossible to enforce.

President Vladimir Putin has made it a top priority to improve Russia's investment climate, and his government has recently moved to lower taxes, cut red tape, ease currency controls and liberalize obsolete labor laws. It has also embarked on wide-ranging judicial reforms that include stripping public prosecutors of their supervisory role in private litigation.

Sawyer became a shareholder of the Gus-Khrustalny Quartz Glass Plant, a Soviet-era factory producing high-purity technical glass, when it was privatized in the early 1990s. Then in 1997, when the plant was declared bankrupt, Sawyer launched a restructuring plan. It paid off \$1.5 million in debts and took out a 25-year lease on one of its workshops, fitting it out with new equipment to make world-standard electronic grade quartz. The

company says it has invested a total of \$7 million in the plant.

But soon afterward the local prosecutor declared the agreement with Sawyer invalid, saying the Quartz Glass Plant was a strategically important asset which couldn't be rented to a foreign company. Sawyer fought off a series of legal challenges but last May a local court invalidated the lease and ordered Sawyer off the plant. It also allowed two of the plant's Russian creditors, ROEL and Vladimirtechnoservice, to take control of Sawyer's production facility.

"The contract had to be revoked because it harmed Russia's state interests," said Dmitry Dorokhin, a lawyer for ROEL. He said ROEL and Vladimirtechnoservice had tried to reach a deal with Sawyer by proposing a joint venture on the basis of the plant and creating new quartz processing facilities. "We discussed various options but they were unwilling to compromise," he said.

Exhibit 14

March 2, 2002

THE ECONOMIC SITUATION AND INVESTMENT CLIMATE IN RUSSIA

Analysis of 2001 changes and long-term prospects for the Russian economy

Written by [The Expert Institute and American Chamber of Commerce](#)

This report was prepared by the Expert Institute and the American Chamber of Commerce in Russia, with contributions from Ernst & Young as a background to the Forecast Conference "Russia on the Rise".

The report will analyze the changes that took place in 2001, their impact upon the investment climate and long-term prospects for the Russian economy, and will focus the attention of the business community in Russia and the Russian Government on the most urgent problems facing the Russian economy at present.

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INTRODUCTION

This report was prepared by the Expert Institute and the American Chamber of Commerce in Russia, with contributions from Ernst & Young as a background to the Forecast Conference "Russia on the Rise".

The report will analyze the changes that took place in 2001, their impact upon the investment climate and long-term prospects for the Russian economy, and will focus the attention of the business community in Russia and the Russian Government on the most urgent problems facing the Russian economy at present.

The investment climate will be a key issue for the Russian economy in the coming decade, since the extent to which the economy is business- and investor-friendly will determine how successfully Russia can overcome the difficulties of this transition period and modernize its economy to guarantee stability and prosperity for its people and a rightful place for Russia within the world economy.

Modernizing the economy will be Russia's strategic objective for the coming decade. Russia must enhance its economic competitiveness on a global level and create conditions conducive to long-term and stable growth. That will require the development

of an appropriate official policy and the creation of conditions conducive to effective economic decision-making.

The Expert Institute's contributions were drafted by Yu. A. Danilov, A.V. Kosygina, and Professor E.G. Yasin who supervised the project.

2001 - a summary

The Russian economy has seen an upturn over the past three years (1999-2001). Last year was a relatively good year for Russia, in spite of the difficulties and problems that afflicted the wider global community. The main trend now emerging in Russia is stabilization. The State is consolidating its control functions, the economy is expanding, and political and macroeconomic risk factors have been significantly reduced. The Russian stock market was one of the fastest growing and most profitable markets in the world in 2001. The economy is displaying considerable resilience and is likely to continue expanding through 2002, despite the worldwide economic downturn and the fall in oil prices.

Consumer spending and investment expenditure have grown at dizzying rates and pushed up demand, taking their place alongside those other factors that have typically contributed to economic growth in Russia in recent years (high prices for Russia's traditional export commodities and the 1998 ruble devaluation, which encouraged domestic manufacturing to replace imports). This has led to growth in economic sectors that are primarily focused on the domestic market.

Russia has now passed through the first phase of the economic transformation process - macroeconomic stability has been achieved and a basic market environment has been created. More importantly, the main institutions required in a market economy now exist, and most business entities now operate on the basis of business drivers and signals that are typical of a market environment.

In 2000, under President Putin, the Government published a Social & Economic Policy Program 2000-2010 (the Gref Program) that demonstrates an understanding of the threats currently facing the country and which offers a development strategy based on a series of social and economic reforms intended to create a liberal market economy, governed by a democratic political system. The Program was widely endorsed by the business community in Russia, and refers to the task of improving the investment climate as one of the most important issues facing Russia today.

Last year was a good year for the Russian authorities insofar as the implementation of the Gref Program is concerned, especially for the Government and State Duma, since they made marked progress in implementing some of the measures required to improve the investment climate. The Government's plan of action for 2000-2001 in the area of social policy and modernization of the economy has to all intents and purposes been implemented.

The consolidation of the Federal Government's authority in the regions (via the

Presidential Representatives in the Federal Districts) has regional legislation into line with federal law on most issues, thereby overcoming the fragmentation of the national economic territory while reducing administrative barriers and risks.

Last year also saw substantial progress made in improving legislation governing economic, business and investment activity. The year 2002 will see the entry into force of the Labor Code and Land Code, four chapters of the Tax Code, and a number of other fundamental laws governing economic activity. These new laws are creating the conditions needed to consolidate and develop market economy institutions and to improve the investment and business climate in Russia. Nevertheless, there remain a number of important unresolved issues concerning inter-departmental regulatory coordination that are holding back the implementation of the Government's program.

This year will see further lifting of the tax burden (the Government has promised to now focus its attentions on reducing the tax burden on business), a more liberal currency regulation system, and a further reduction of administrative barriers: simplified procedures for registering legal entities, streamlined inspection procedures, and fewer licensing requirements. This year will also see the first stages of a pension reform initiative that will result in the transition from a pay-as-you-go system to a funded system, which will include changes to the procedure for turning savings into investments that should result in an increase in long-term investment.

Developed, effective forms of cooperation between the business community and the Government are gaining added impetus: meetings between senior government officials and the American Chamber of Commerce in Russia, the Russian Association of Industrialists and Entrepreneurs, the Foreign Investment Advisory Council, and other organizations representing the business community; ongoing consultations between the business community and government agencies in the context of drafting legislation affecting economic issues, etc.

However, what has been achieved to date is not in itself enough to guarantee an improvement in the investment climate and a long-term revival of the economy. Despite a general economic recovery, problems of a strategic nature remain.

Until we see stable growth in the output of competitive products, it will be too early to speak of a stable economic growth pattern. That applies not only to the raw materials sectors, but also to secondary industries and services, and it will require massive investment into industrial plants and equipment, the widespread deployment of new technologies, and an improvement in economic management in practically all sectors of the economy. That is the real essence of the Government's task of modernizing the economy, as laid out in the Gref Program. It is a task that we are only just beginning to address.

Modernization of the Russian economy will result first and foremost in stable growth in domestic demand, thereby reducing Russia's dependence on the international raw material and oil markets. However, there is still a long way to go before we reach that stage.

Increasing economic globalization is forcing all countries to make effective use of resources and increase the competitiveness of their industrial output. It is also forcing countries to ensure that they can adapt flexibly and rapidly to changing external circumstances, which essentially requires access to global information flows and the ability to make effective decisions in the light of long-term development strategies and resource constraints.

Thus, it will not be enough for Russia merely to achieve high growth rates. We must also modernize the economy, ensure structural changes and actively foster global economic links if we are to enhance the long-term resilience of our economic system. To that end, we must create conditions conducive towards generating revenue and increasing in-bound investment, and make more effective decisions on how we use our resources and promote our goods on the market.

Over the past three years, investment growth has outstripped GDP growth in relative terms. However, we are not making full use of this country's investment potential, as the mechanisms for transforming savings into investments are ineffective, resulting in a situation where total savings in Russia significantly exceed total capital. Sector-to-sector capital flow is also at a very low level. In terms of investment resources, there is a clear misbalance in supply and demand between the export-oriented raw materials sectors and the rest of the economy, which is in dire need of capital.

That is in many ways linked with the structural and pricing specifics of each individual industry and of the natural monopolies, as well as the inadequate nature of the financial system, the high degree of mistrust among businesses, and inadequate protection of ownership rights, all typical features of the current Russian economy.

The year 2001 was an extremely good year for the Russian financial system, which has now recovered in the main part to its pre-crisis position. However, despite the substantial progress made with regard to legal regulation of the financial sector, institutional problems continue to prevent this sector (particularly the banking system) from expanding to meet the needs of the economy. These problems include a general lack of transparency throughout the economy, an under-developed deposit guarantee system, a near-absence of risk-management tools, and under-capitalization and poor consolidation within the banking sector. Until we create conditions that are conducive to developing the financial system, to an unimpeded flow of resources between financial markets, and to the emergence of risk management tools, then problems associated with the ineffective transformation of savings into investments will go unresolved, and consequently there will be no significant influx of investment into the economy. Russia needs to accelerate the development of its financial sector, and first and foremost - of its banking system.

The Government's achievements regarding reform of the natural monopolies, meanwhile, have been modest. A framework has been laid down and a plan formulated for the reform of the "RAO UES Russia" energy monopoly. The strategy for reforming Russia's railways, however, leaves many questions unanswered. Almost nothing has been done with regard to the reform of Gazprom. However, the reform of these three

monopolies is of crucial importance to business in Russia, as trends in energy, gas and transportation tariffs have a major impact on the costs and risks incurred by manufacturers. In the absence of any projection of how these key economic factors may evolve in the medium term, most businesses are unable to plan their operations or implement investment projects (particularly where such projects are large-scale or have long-term returns) running over similar or longer timelines.

The process of redistributing assets has intensified. The number of petitions filed with arbitration courts to have debtors declared bankrupt in the first half of 2001 was greater than for the whole of 1998. These trends are due in part to the strategic interests of prosperous exporting industries, and are leading to capital consolidation, which in turn is having a positive impact on the intensity and quality of investment processes. However, it would be unwise to focus solely on the development of major multi-profile conglomerates and to look on their internal reserves as a primary source of investment. We need to foster Russia's financial markets and banking system so that private savings and the financial resources of small and medium enterprises also become a productive source for investment, to promote more effective investment-related decision-making, and to encourage more competitive bidding for investments.

While the examples of asset redistribution cited above may be viewed as one aspect of a process of industrial recovery involving the transfer of capital to more effective owners, in many cases the struggle for control of assets has fewer noticeably positive consequences for the economy, or even no positive consequences at all. This is particularly true in the case of staged bankruptcies aimed at taking over enterprises and taking advantage of loopholes in existing bankruptcy legislation, and of struggles for control over government-run entities which generate substantial financial revenue.

Last year saw an intensification of certain trends that can have a destructive impact on the business climate and that may in the future have more serious consequences for the economy.

Most prominent among those destructive trends are the increasing centralization of executive authority, the drop in public confidence in the electoral system and in all official institutions (with the exception of the Presidency), the increased role and influence of state-controlled mass media throughout the Federation, and the use of the Office of the Prosecutor General to exert pressure on businesses. All of the above trends fuel the suspicion that the traditional disparity between a Russian official's word and deed and longstanding manipulation of the law continue to flourish.

It is vitally important for Russia to overcome these trends if we are to create conditions conducive to long-term economic growth, modernization of the economy, and the successful implementation of the program of social reforms. They are impairing Russia's investment ratings, undermining confidence in the statements and actions of the authorities, adding to the uncertainty, and hence the risk factor, for investors, threatening ownership rights and damaging business reputations.

Legislative reform is only the first step on the road to improving investors' perceptions of

the investment climate in Russia. Real progress will also require proper enforcement, which in turn will require an independent and fully qualified judicial system and a capable, effective and unbiased enforcement apparatus. Looking back on last year, it is clear that the judicial system is in the throes of a deep and profound crisis. Its lack of independence from the executive branch is clear to and recognized by all, a fact which is having the worst possible impact on how Russia's investment climate is perceived.

There is a clear need to reform the public administration system in Russia. The public service in its current form is incapable of creating the environment for the normal evolution of Russian society in democratic, market economy conditions. The administration's decision-making mechanisms are ineffective and slow, and the administration itself is both corrupt and inefficient. Many of the decisions made by the administration are far from beneficial in terms of their material cost and their value to society. Society, meanwhile, has no real means of holding official bodies accountable for their actions.

The tragic events of September 11, 2001, marked a new departure for the global community. Those events have necessitated the formulation of a new set of rules and mechanisms aimed at fostering stable development and peace within communities. They have also provided Russia with an unprecedented chance to drastically improve its standing in the civilized world, since it is now widely recognized that this country has an active and vital role to play in the creation of a new and stable geopolitical system and global economy .

The Russian President demonstrates an understanding of the problems facing Russia, and a willingness to address these problems. However, decisions made at the top will not be enough to carry through full-scale reform of the system. On the contrary, such an approach can only lead to an upsurge in disruption, interference, and in-fighting within the areas of financial flows and administrative resources.

Events of last year have revealed, in particular, an entrenched bureaucracy attempting to establish the preeminence of the State over the mass media, particularly at the federal level. The mass media appear to be viewed by the State as a tool for manipulating public opinion, a view which refuses to recognize that freedom of information is vital to the proper functioning of a modern society.

However, the Gref Program's insistence on the importance of private initiatives, coupled with the sheer complexity of the reforms that are needed, means that the Government will require the sustained backing of the public for key aspects of its reform policy.

Last year was a good year for Russia overall, although the global community as a whole was faced with a new set of challenges and threats, and the world economy slipped into recession. The Russian economy has already developed most of the mechanisms typical of a market economy and is now relatively stable. The Government is actively working to improve the investment climate, by amending and developing legislation, and adhering to liberal values in most aspects of its economic policy. Nevertheless, the country's investment infrastructure (banking system, stock market, mechanisms for protecting

property rights, etc.) is in desperate need of development if it is not to become an obstacle to economic growth. In all, there is a need to step up the process of modernizing the economy, to intensify the pace of structural reform, and to tear down administrative barriers to the development of business. Further consolidation of state power will undermine the reform process if it is not accompanied by administrative reform and if the institutions of a civil, democratic society are prevented from emerging. The year 2001 was a milestone year in the contemporary history of the global community. It has instigated changes to many of the principles that hitherto governed the geopolitical makeup of the world. It has given Russia an unexpected chance to dramatically improve its lot, to integrate with the rest of the global economy making fewer concessions than before, and to resolve a number of longstanding, problematic issues, particularly insofar as relations with the West are concerned. It would be unacceptable for Russia to forego this unique and historic opportunity.

1. ADMINISTRATIVE MANAGEMENT AND ECONOMIC POLICY

Last year saw an intensification of trends that emerged in 2000 with regard to administrative management and economic policy. One aspect of those trends is seeing the ongoing consolidation of the institutions of state power coupled with further liberal economic reforms, factors which are alleviating political risk.

Another aspect concerns the ongoing centralization of executive functions. This entrenchment of the bureaucratic machine has its roots in history, and has in the past stymied more than one reform initiative. At present it is enabling the President to pursue the chess strategy known as "sacrificing quality to gain tempo". In the long-term, however, these trends may come into conflict with each other.

The executive branch has most notably consolidated its positions along the hierarchical axis. The ban on regional governors also representing their regions in the Federation Council and the ending of gubernatorial influence over regional agencies of the Interior Ministry have reduced the scope for regional leaders to pursue policies at odds with those of the federal headquarters. This has had a positive impact on the political weight of decisions made at the federal level, stamping out voluntaristic tendencies on the part of the regional authorities, and ending organized gubernatorial opposition to the Presidency.

The removal of the governors from the upper chamber of the State Duma and the emergence of a Duma majority allied with the Presidency led to unprecedented legislative activity last year. Moreover, the Presidency and the federal ministries have turned into the single most influential initiator of legislative proposals, which now instigates the majority of legislative proposals considered by the Duma.

However, Russia's system of government is lacking in checks and balances. It is too reliant on subjective factors such as the intentions and quality of the people who occupy the key posts, and, first and foremost, those of the person occupying the Presidency. Not one government body is as influential or enjoys such authority as the President, while over the past year, the prestige of the institutions of democratic government has

fallen.

Russia's political system remains under-developed. All political parties that have opposed the current President on whatever issue, whether they be on the left or right of the political spectrum, have seen their positions weakened as a result. Meanwhile, the centrist parties that have formed a pro-presidential majority in the Duma cannot really be looked upon as genuine political parties insofar as they lack an ideological standpoint and an independent political platform.

The institutions of civil society remain weak. A dearth of resources is preventing them from taking on a sustained opposition role and resisting government measures that run counter to the interests of society.

Last year saw a smaller turnout in the parliamentary elections. On the one hand, that points to a drop in confidence in the electoral system and a lack of faith in the importance of one's vote to the outcome of an election, and on the other hand to a fall in the authority of Parliament. Poor electoral participation is having a corrosive effect on the development of the political system. It is leading to an excessive concentration of power in the executive and in the Presidency, rendering the government less sensitive to signals emanating from society and the economy, and making it unable to recognize the diversity of those signals. That in turn means that political and economic decisions are increasingly tailored to the interests of ever-narrower social groups.

One trend that is having contradictory consequences is the active infiltration of the legislative and executive branches of regional power by representatives of major business. Such initiatives are on the one hand motivated by a desire to reduce business costs and enhance the quality of the public services used by businesses. On the other hand, however, this fusion of politics and capital will lead to the continued existence and indeed flourishing of the conditions that allow unfair competition unless legislation is finally put in place determining how public servants should act in the event of a conflict of interests, and unless the official decision-making process is rendered transparent.

The consolidation and centralization of state power in a context of poor transparency and a lack of accountability to the public creates fertile ground for corruption and encourages administrative officials to obstruct the privatization process for the purposes of personal enrichment. The task of fostering economic development very often moves to the bottom of their priorities.

The current administrative apparatus is unable to cope with its functions . It is incompatible with the needs of a democratic society and open market economy that is integrating with the rest of the global community and participating in the process of globalization.

For one thing, it is incapable of abiding by the rules, which is vital for democratic and market institutions. This problem is primarily the result of ineffective decision-making mechanisms, corruption, and a total lack of transparency within the administrative bodies.

Second, the quality of services and solutions offered by the public service is sub-standard. This is primarily due to specific aspects of how decisions are made and how public services are organized, in addition to aspects of public servants' motivation and the nature of the resources they rely upon.

Third, resource wastage within the public service and government apparatus has reached dangerous proportions. Public bodies are overstaffed with under-qualified civil servants, and the government is unable to bring itself to hire specialists with advanced qualifications who could each replace 5-6 incompetent technical functionaries.

Administrative reform must be based around three relatively autonomous objectives:

- enhancing transparency; better regulation of public servants responsible for political and administrative decision-making;
- resolving the issue of conflicts of interests.

Administrative reform is an essential step on the road to enhancing the investment climate in Russia since the current state of the administration means that risk, entry and exit barriers, and transactional costs are at unacceptably high levels.

As far as economic policy is concerned, the Government consistently sticks to the liberal course announced in 2000. Last year saw the drafting of laws that will play a fundamental role in carrying through major structural reform and in improving the investment climate. They included laws on economic deregulation, laws aimed at alleviating administrative and other barriers to investment and business activity, laws aimed at enhancing protections afforded to property rights, laws aimed at ensuring fair and equal competition, labor law reform, pension law reform, laws aimed at fostering the use of information and telecommunications technologies in various spheres, etc.

The Government has become more open with regard to the drafting of new legislation on economic issues. Most draft laws are published at various stages of the drafting cycle on ministries' websites (primarily on that of the Ministry for Economic Development & Trade), and the Government consults as a matter of course with representatives of the business community, whose suggestions are usually incorporated into the new laws at the drafting stage (rather than in the form of amendments to existing laws, which is a much more costly process).

Thus, we are seeing the emergence of an effective system of cooperation between government and business, under which representatives of the business community, or at least a significant proportion thereof, actively contribute to the drafting of economic legislation and economic policy from the very outset. This is a positive trend that will ensure a more effective and resilient economy, social stability, faster growth rates, and reduced uncertainty. For example, the new rules for calculating export duty on oil, which enable a faster reaction to fluctuating oil prices and alleviate the uncertainty factor that complicates corporate planning, were devised by the Government in consultation with the oil industry.

Economic modernization also means changing the structure of the economy so that the

energy and raw materials sectors no longer predominate, developing high-tech manufacturing industries, enhancing the competitiveness of Russia's industrial output, and consolidating its positions on the markets. That process will not take place spontaneously under the influence of market forces. It will require active intervention by the State in the form of an appropriate government policy.

Structural policy, it has to be said, is the weakest link in the Russian Government's economic policy chain. The system of pricing continues to be distorted by direct and hidden subsidies, thereby clouding perceptions of the effectiveness of various forms of business, and misrepresents corporate and household finances. This problem is a strategic one for the Russian economy, and its resolution will inevitably lead to structural change. It would be naïve, however, to expect it to resolve itself or to become irrelevant. For one thing, structural reform will lead to a redistribution of added value and profits between sectors and industries, meaning that the losers will come out against the reforms. Some of these "future losers" enjoy considerable lobbying power. On the other hand, guessing which industries are likely to become the cornerstones of the Russian economy in the coming decade is a thankless, and indeed futile, task.

Considering the current state of the economy, government policies of recent years, and the need to build a modern market economy, the tasks facing the Government at present are as follows:

- to ensure fair and equal competition for all businesses by removing all tax and other exemptions, and protectionist measures enjoyed by individual companies, by removing subsidies, and by remedying unequal administration and inspection measures, along with unequal access to public services;
- to prevent any increase in the tax burden aimed at funding public investment and subsidies;
- to alleviate the administrative, technical and other barriers to market entry;
- to enhance the transparency of economic processes in both the private and public sector.

The Government's priority task must be to strip away the administrative barriers to the development of business. Small enterprises suffer from the greatest level of exposure to changes in the investment climate, reduced access to lending resources, and increased administrative pressure. Small enterprises have been emerging at a very slow rate over recent years (the number of small businesses in Russia has remained around 880,000 over the past three years since the crisis), and have been slow to make the transition to legality.

In light of Russia's forthcoming accession to the WTO, an effective policy needs to be devised with a view to supporting Russian exporters in the context of the restrictions that come with membership of that organization and of those principles underpinning the current economic policy. In recent years, the Government has resorted to direct subsidies as a means of supporting exporters. With WTO membership, that will no longer be possible, quite apart from the fact that such an approach is at odds with the goal of enhancing the competitiveness of Russian products in that it removes the

incentive to pursue greater efficiency.

Foreign policy has also become an important aspect of the economic reform drive. The recent breakthrough in Russia's social and political relationship with the West came about as a direct result of President Putin's immediate and decisive reaction to the tragic events in New York and Washington, his firm position and clear vision on Russia's participation, place and role in the anti-terrorist coalition, and the measures he undertook to aid and assist the allies. This moment may become a turning point in Russia's contemporary history, provided the opportunity it provides is not forsaken.

The changing political situation has the potential to exert a positive influence on investor expectations. Indeed, economic reform will be easier to carry through successfully if the Government adopts a strategic course towards integration with Western civilization. Specific evidence of the changing political situation is to be found in the fact that the process of declaring Russia a market economy has now been revived, talks are once again underway on Russia's accession to the WTO, plus there has been a seismic shift in Russia's economic relations with the US that was the abrogation of the Jackson-Vanik Amendment. The US is one of the top direct investors into the Russian economy, and the development of trade and economic relations with that country should be a matter of utmost priority for Russia.

Because President Putin has demonstrated his intention to carry on with liberal economic reform, the current state of the political system and the configuration of forces in the administration are allowing him to pursue the chess strategy of sacrificing quality to gain tempo. The system that is emerging will, however, be unstable in the long-term, will obstruct entrepreneurial initiative, give rise to additional risks and costs for businesses, and may even lead to the failure of the entire reform process. The changing geopolitical situation, meanwhile, has opened up a number of opportunities for Russia, the realization of which will require the coordination of a range of key government policies: a liberal economic policy coupled with a foreign policy aiming for integration with the global community and rapprochement with the West, and a domestic policy aimed at fostering the institutions of democracy. A solution to these tasks will only be found through an overhaul of the administrative apparatus.

2. INSTITUTIONAL REFORM

Last year was marked by intensive preparations for institutional reform aimed at modernizing the institutions of State, completing the formation of market economy mechanisms, and creating conditions conducive to long-term stability and sustained economic development in the context of a post-industrial global economy. Indeed, by their very scale, the transformations in question will lead to a veritable revolution in the life of our society. By no means all of the changes initiated in 2001 managed to bear fruit last year. Some of them, however, will undoubtedly have a long-term positive effect, including with regard to the investment climate.

Many of the Government's reform initiatives last year were aimed at effecting change in the institutions of government, the financial system, the laws on ownership rights, and

the social sphere. The most important changes concerned tax, pension and labor law, the beginning of reforms with regard to the natural monopolies, the institution of measures aimed at ensuring greater economic deregulation and alleviating administrative barriers, and the enhancement of protections afforded to investors and owners.

Basic groundwork has been carried out with a view to redirecting financial flows into the manufacturing sector and enhancing the role of savings in the economy. The tax burden is gradually being reduced. The pension reform due to begin in 2002 will see the transition from a PAYG principle to a funded system. A legal framework has been introduced to regulate the activities of institutional investors -- pension and investment funds. That measure will encourage the general public to save and increase the number of long-term investment projects.

Work is continuing on budgetary reform with specific reference to such issues as the structure of consolidated budget revenue and expenditure, the balance of financial flows between federal, regional, and local budgets, better transparency and efficiency in government finances, and the safeguarding of macroeconomic stability. The Government is also working on reform packages for the military, the education system, the healthcare system, housing, and a number of other issues.

The adoption of the "E-Russia Program" is an event of supreme importance that will enable the continued integration of Russia into the global digital economy, enable greater openness with regard to information flows, facilitate access to new technologies, and intensify commercial and investment activity.

A judicial and legal reform initiative has been devised that will lay the grounds for alleviating many of the risk factors currently besetting the economy, enhance public confidence in the judiciary and law enforcement system, enhance the stability of the State and society, and guarantee civil rights and liberties, particularly with regard to the politically and economically active sections of the Russian population.

Negotiations on WTO accession and stronger economic ties with the EU and US have been given added impetus (partially due to the altered international situation), in a process that will lead to increased integration with the global economy, the removal of anti-dumping sanctions against Russian exporters, and the liberalization of the economy. This new level of economic involvement will necessitate an array of changes to Russia's economic policies, and lead to significant progress from the point of view of structural reform. While in the medium-term the conditions of Russia's accession to the WTO will have a major impact on the competitiveness of Russian industries and companies, in the long-term it will be specific aspects of individual companies, such as their ability to adapt to changes at the micro and macro levels, that will determine how competitive the Russian economy is as a whole.

The institutional reforms mentioned above are already enhancing the investment appeal of the Russian economy. The international rating agencies, for example, have upped Russia's credit rating to a level that makes Russia one of the most attractive emerging

markets at the moment. However, our country's institutional reform process is only just beginning. Major advances in the socioeconomic system, and, accordingly, an improvement in the investment climate, will only become apparent after the institutional reform program has been carried through.

3. THE MACROECONOMIC SITUATION. INVESTMENT

Last year was the third growth year in a row for the Russian economy, with the rate of growth outperforming the average global growth rate. The progress achieved in many areas was the best in a decade. After a lengthy and profound decline, Russia has recovered to its GDP and industrial output levels of 1993-1994.

Set against a backdrop of falling economic performance throughout most of the developed world, Russia shows up favorably as a robust and resilient economy. While the fall in international prices for oil and metals will have a negative impact on economic growth rates, public finances, and revenue collections in general, the effect will not be as catastrophic as in 1998 when a budgetary crisis coupled with falling oil prices and upheaval in the international financial markets led to a full-blown macroeconomic meltdown. Russia has every reason to expect continued economic growth in 2002 (despite the slowdown observed at the end of 2001).

Last year was the first year since the beginning of a transition period in which increased consumer and investment expenditure contributed significantly to aggregate demand, leading to a new revival in the Russian economy brought about by the current market situation. In spite of the fall in prices for most Russian export commodities, which led to depressed export revenues and a drop in the balance of trade, Russian companies refrained from cutting their investments in Russia and even cut back on capital exports.

Another important factor sustaining the high rate of economic growth was seen in a more balanced approach taken with regard to public finances, maintenance of the budget surplus, and a balanced approach taken towards curbing inflation and keeping the ruble stable. All of the above is crucial to macroeconomic stability and to promoting confidence in the ruble (2001 was the first year since the beginning of the transitional period when the State outperformed the private sector in terms of capital exports).

Russia's substantial foreign currency earnings from exports have led to increased monetization throughout the Russian economic environment. Barter and payment defaults, which seriously destabilized the financial system throughout the 1990s, have fallen to a level whereby they no longer impact upon economic activity in any significant way. Barter transactions have fallen to 15% of all transactions carried out in Russia from the 45% level that existed prior to the 1998 crisis.

Table 1

Main macroeconomic indicators

[illegible]

	1998	1999	2000	2001
Real GDP, % of previous year	95.1	105.4	108.3	105.1
Industrial output, % of previous year	94.8	111.0	111.9	104.9
Capital investments, % of previous year	88.0	105.3	117.4	108.7
Real disposable income, % of previous year	83.8	86.2	109.3	105.9
Retail turnover, % of previous year	96.2	93.5	108.7	110.8
Unemployment, %	13.3	12.2	10.45	8.96
Balance of trade, \$ bln	16.9	36.1	60.7	50
CB gold and foreign currency reserves, \$ bln, year end	12.2	12.5	27.95	36.6
In terms of monthly volumes of import	2.5	2.9	5.4	8.3
Consolidated budget deficit (-), surplus (+), end of period	-5.7	0.9	2.0	2.0
CPI, % December-to-December	184.4	136.5	120.2	118.6
Increase in nominal exchange rate \$, %	346.5	130.8	104.3	107.0
Monetary mass increase (\dot{I}_2), % of previous year	106.1	144.2	147.1	125.8
Average oil price - Brent (\$ per barrel)	13.3	17.8	28.3	24.4
Central Bank interest rate, year end, %	60	55	25	25
RTS index, close of trading on last trading day of year	58.93	175.26	143.29	260.05

Source: State Statistics Committee, Central Bank, Expert Economic Group, World Bank

The Russian economy is now dominated by business entities that think in terms of market economy and are guided by the signals and drivers that exist in any normal market environment (price, profit norms, etc.) rather than being preoccupied with the fight to head off manifestations of macroeconomic problems at the microeconomic level (barter, payment defaults, hyperinflation). Moreover, the stronger ruble is leading to increased imports, a factor which is driving competition and forcing business entities to come up with new ways of turning a profit.

The non-market sector of the economy , which exists thanks to subsidies and preferences rather than its own intrinsic efficiency, has stopped expanding. The number of people employed at industrial enterprises that fall into this category has fallen sharply since 1997.

Despite the abovementioned, however, the current economic situation is by no means a cause for euphoria. The end of last year saw a slowdown in industrial output growth, falls in profits, and a drop in world oil prices. Productivity remains extremely low at Russian enterprises -- several times lower than at American enterprises . The pace at which industrial plants and equipment are renewed is too slow, and Russian goods suffer from impaired competitiveness even on the domestic market, as witnessed by the increase in imports and fall in industrial output at the end of 2001. These tendencies show that the Russian economy is still in transition and point to instability of growth in the long-term and an over-reliance on the international oil market.

The key issue is to transform savings into an investment resource and to redirect capital from the high-revenue export-oriented sectors to other sectors of the economy. However, that is happening at an unacceptably slow pace. Russia's positive trade balance is not bringing enough investment resources into the economy and is failing to realize the potential that exists for growth in aggregate demand and output. The Russian economy is presently displaying an inadequate capacity to absorb investment resources: despite gross national savings representing more than 32% of GDP, gross accumulation is less than 20%. Thus, the task of improving the investment climate should not be seen as one of identifying available resources that can be attracted into the Russian economy, but rather as one of removing the administrative and institutional barriers that are hampering investment processes.

Table 2

Structure of GDP allocation (as a % of the total)

	1995	1996	1997	1998	1999	2000	2001*
GDP (market prices) - total	100	100	100	100	100	100	100
of which:							
Final consumption	71.2	71.4	74.8	76.6	68.2	62.5	66.2
Gross accumulation	25.3	24.5	22.3	16.2	15.0	17.1	20.5
of which:							
Gross accumulation in capital assets	21.2	21.1	19.0	17.7	15.8	17.8	21.5
Change in material current asset reserves	4.1	3.4	3.3	-1.5	-0.8	-0.7	-1.0
Net exports of goods and services	3.5	4.1	2.9	7.2	16.8	20.4	13.3

Source: State Statistics Committee, "Russia in Figures 2001"

*estimated

A distorted relevant price structure is one of the most important problems afflicting the

Russian economy. The historic structural proportions and pricing principles that formed within the context of the planned economy (as a result of which the Russian economy inherited excessively low energy and transportation tariffs and a generally low-yield and uncompetitive secondary industry) and were transplanted to a market environment, have distorted the entire system of economic signals (prices, tariffs, interest rates, ruble exchange rate) so that the energy sector now subsidizes the entire economy. This transplantation of aspects of one economic system into another has also led to other overt and covert forms of subsidization, and has removed the incentive to save energy, modernize plants and equipment, and enhance efficiency, with the result that some businesses generate negative added value. Another subsidy is to be found in the artificially low charges for housing and utilities, electricity, and rail transport, which are keeping wages at an artificially low level within the economy as a whole, and in particular in the public sector and non export-oriented industries.

Until structural reform is instituted and these price distortions are resolved, the Russian economy will remain trapped within a series of vicious circles: a stronger ruble leading to a fall in the competitiveness of the manufacturing sectors and an increase in imports of consumer goods; increased revenues from raw materials exports leading either to increased inflation in a context of growing foreign currency and gold reserves, or to an excessively strong ruble; and the dearth of investment opportunities within the economy resulting in capital flight. The overall result will be poor yields, low (or negative) growth rates, a fall in the quality of capital and labor resources, and an overall worsening of the economic situation.

Economic modernization will also require significant improvements in labor productivity, plant renewal, and the deployment of modern management methods. It is of utmost importance for the Government to aim to increase the specific weight of processing-intensive industries and to raise the country's industrial infrastructure to a level consistent with modern technical and technological requirements. That will require the liquidation of price distortions and the elimination of non-market remnants from the economy, which will in turn require reform of the energy monopolies (RAO UES Russia and RAO Gazprom), the housing sector, and the transportation sector¹².

The profound economic decline that has taken place over the past ten years and the need for modernization will necessitate investments in the region of several dozen billion dollars in order to achieve a qualitative breakthrough and create conditions conducive to stable long-term growth. Despite Russia's growing attractiveness as a foreign direct investment destination, foreign direct investment remains low (substantially below the rest of Eastern Europe at only 1.7% of GDP in 2000).

Table 3

Foreign direct investment, 2000

	\$ bln.	% GDP

Russia	3.3	1.7
Czech Republic	5.1	9.6
Poland	7.4	4.7
Hungary	2.0	4.1
Romania	1.0	2.8
Bulgaria	0.8	6.5
Latvia	0.35	6.7
Lithuania	0.49	4.6
Estonia	0.3	6.0
Ukraine	0.5	1.6

By the end of September 2001, aggregate foreign investment in the Russian economy had reached US\$34.4 billion (including investments from other CIS countries). In the first three quarters of 2001, foreign investment in the Russian economy amounted to US\$9.7 billion, which represented a 23.2% year-on-year increase. Structurally speaking, foreign investment in the Russian economy underwent the following changes: portfolio investment was up 4.95% y-o-y (to US\$0.3 billion), other investments were up 39.2% to US\$6.5 billion, and foreign direct investment was down 7.4% y-o-y in January-September 2001, to \$2.9 billion.

Table 4

Structural overview of foreign investment in Russia

	Total, \$ bln.	Direct, % of total	Portfolio, % of total	Other, % of total
1997	12.3	43.4	5.5	51.4
1998	11.8	28.6	1.6	69.8
1999	9.6	44.6	0.3	55.1
2000	10.96	40.4	1.3	58.3
2001*	9.7	30.0	3.0	67.0

* January-September 2001. Source: State Statistics Committee

The year 2001 saw a fall in Russia's external sovereign debt on the back of an intensive repayments drive (US\$5.6 billion repaid January-November, 2001, according to the Economic Experts Group's data), while the country's domestic debt remained more or less unchanged, increasing by only RUR 13 billion in the period January-October. In our view, these structural changes have substantially enhanced the effectiveness of Russia's sovereign borrowings. There has been a substantial decrease in the foreign debt burden and in interest expenses thanks to a net strengthening of the ruble (foreign debt fell below 50% of GDP last year so that now the country's foreign debt may be categorized as moderate), suggesting that proper advantage was taken of the favorable macroeconomic circumstances that emerged in 2001 to improve the parameters of Russia's sovereign debt.

Under different conditions (e.g., if export revenues fell, if the ruble began to fall, if spending on social programs increased in the lead up to the elections), it would be considerably more difficult for Russia to service its foreign debt. For that reason it is important to take advantage of the current window of opportunity to identify other ways of servicing the national debt, such as via a special debt servicing fund, or through borrowing on the domestic market. Another potential source of financing is the external market, and the possibility of partial restructuring.

Now that the effects of the 1998 crisis have been overcome, new possibilities have opened up for increasing borrowing on the domestic market. We must, however, be very careful in this regard and keep within a strict legal framework that at present does not exist. The only way to increase domestic borrowing with minimum damage will be to diversify debt instruments in such a way as to attract new investors into the debt market. Economically-sound borrowing and yield ceilings must be put in place with regard to government securities.

The new opportunities for domestic borrowing are a direct result of the increase in Russia's credit rating. Foreign borrowing must be conducted over the next few years with a constant vigilant eye to the current temporary structure of Russia's debts.

The Russian economy is experiencing growth for the third year in a row, with growth rates currently outperforming the global average. Macroeconomic stability has been established. Market oriented business entities have begun to emerge at the microeconomic level. Growth is set to continue in 2002, despite the deteriorating situation on the main export markets. However, the slow pace at which the economy is modernizing is undermining the prospects for long-term growth and enhanced competitiveness. Those objectives necessitate structural reform and an improved investment environment, and in particular, a better developed investment infrastructure, better transparency throughout the economy, the elimination of price distortions, and the fostering of confidence through more effective application of the law and better enforcement of contractual commitments.

1. legislation and judicial protection

The year 2001 saw an unprecedented level of legislative activity, confirming the theory that the current political climate is conducive towards significant and indeed rapid improvements in legislation governing investment and business activity.

Despite the fact that a number of items of legislation still give grounds for consternation on the part of the business community, the face of legislation governing economic relations is on the whole diverging towards the interests of a market economy. An entire legislative package has been adopted, which makes substantial changes to Russian legislation that enhances the business and investment climate.

The increased influence of the federal leadership over legislators has played a positive role, since legislative proposals originating with the Presidency and the Government have in most cases taken into account the interests of all business entities, and have from the outset been based on compromise. Despite the conflicts and opposition that have accompanied the adoption of a number of laws, it has to be said that the Russian elite has achieved better consolidation and is now capable of negotiating compromise solutions to key economic issues. The downside to these positive changes is to be seen in the de facto submission of the legislature to the executive, which is contrary to the principle of segregation of authority and represents a strategically dangerous trend that undermines the social system and leads to excessive bureaucratization in the face of an official policy of deregulation.

Last year the Duma approved a number of extremely important social and economic laws that lay the groundwork for the emergence of a market-based institutional structure, modernization of the economy, and the reduction of counterproductive state intervention in the economy. The new laws pave the way towards deregulation, the reduction of administrative barriers, alleviation of the tax burden, and a more liberal currency regulation regime. New rules have been introduced with regard to the taxation of corporate income and mineral resources, and requirements on the mandatory conversion of foreign currency revenue have been relaxed. New Labor and Land Codes have been adopted, and a start has been made towards reforming the pension system.

The adoption of the Land Code is a major political achievement for Russia and a significant step along the road to a market economy. It also represents a positive signal to businesses and will lead to a renewed revival in commercial activity. The new Code simplifies the procedures for acquiring and assigning land rights, offers better protection for such rights, and reduces the scope for arbitrary decision-making on the part of public servants. This in turn should alleviate the corruption that traditionally surrounds transactions involving land in Russia.

A legislative framework has been adopted that will provide the basis for the transition to a funded pension system. This is of utmost importance to the development of an institution of professional investors, financial markets, and savings and investment processes in general.

The year 2001 also saw a breakthrough in the area of legal regulation of the stock

market. Among the most important documents adopted last year in that regard were the Law "Concerning Investment Funds" and the amendments to the Law "Concerning Joint Stock Companies". These documents take into account the way in which the markets actually function and substantially curtail the scope for abuse of shareholders' rights. Another new law that emerged last year was the Law "Concerning Digital Electronic Signature", which will enable cost savings for market traders and speed up securities turnover. A framework has been created for regulation of the fixed-term contracts market, and regulations have been introduced with regard to marginal trading. The concept of financial advisor has been enshrined in law, making it easier for enterprises to raise financing on the stock market and creating a basis for the regulation of investment banking activity.

The Russian Government has broadly approved the proposed new text of the Law "Concerning Insolvency (Bankruptcy)". The need to rework legislation on bankruptcy arose in connection with the fact that bankruptcy mechanisms were often set in motion for criminal purposes, and that liquidators were not subject to any legal regulation. The draft law also establishes for the first time a set of procedures to be followed in connection with financial recovery measures at enterprises.

The number of administrative bodies authorized to conduct audits and reviews at enterprises has been cut, as has the number of audits and reviews that can be carried out at any one enterprise during a specific period. A "one window" principle has been introduced with regard to the registration of legal entities. The number of activities subject to licensing requirements has been reduced, and the licensing procedures have been simplified, streamlined and standardized.

A new Labor Code has been introduced that represents a new departure in the regulation of labor relations as compared with its predecessor, the hopelessly obsolete Code of Laws on Labor, which was adopted around 30 years ago in the context of the socialist planned economy. The new Code creates a legal basis for balancing the interests of all parties to labor relations, as well as those of the State. It accords new rights to employers, which is of supreme importance to enterprises operating in a market environment and basing management decisions on the criterion of effectiveness. One weakness of the Labor Code is the absence of special collision of law provisions governing the employment of foreign citizens. As a result, foreign employees working in Russia are governed exclusively by Russian labor law. At the same time they are deprived of the protection afforded by the compulsory provisions of more advanced legal frameworks. This state of affairs ignores the generally accepted approach to such issues and existing international agreements applied in the sphere of labor law.

These measures should enable businesses, and in particular, small and medium enterprises, to develop.

One important aspect of the current legislative activity is the fact that it takes into account the trend towards the emergence of a global legislative framework by striving to harmonize federal law with international law. This is another example of change for the better with regard to legislation.

In particular, the Government of Russia has stated its intention to undertake measures aimed at harmonizing Russian law with WTO standards as soon as possible in order to ensure Russia's proper integration into the global community, and to guarantee Russian businesses access to international markets on equal terms. The negotiations on WTO access have been underway for several years now. The recent warm-up in relations with the Western countries, which had been skeptical with regard to Russia's readiness for WTO accession, should however lead to significant progress in the negotiations process.

Work is being carried out with a view to amending the law on standards. New laws are being drafted on quality standards compliance to replace the current law on the certification of goods and services. A separate law has been drafted on technical measures in trade. The implementation of the technical directives will permit a full-scale transition to voluntary standards, thus enabling industry to apply international standards on a broader basis and expand sales markets. At present the task of harmonizing Russian standards with international norms is 40% completed (in Europe, the level of application of international standards varies from 45% in France to 80% in the UK).

Despite the progress outlined above, there remain several serious gaps in Russian legislation, one of which is the virtual absence of legislation governing consumer lending. The existing provisions fail to take into account the specific nature of relations that arise between banks and private individuals in this regard. For example, Russian civil law makes no mention of procedures for concluding consumer lending agreements or additional substantial provisions thereof, on the right of the consumer to withdraw from a consumer loan during a specified period of time, on the procedure for premature termination of such loan agreements by banks, or on lending brokers. Such provisions have, on the other hand, long existed in the majority of European countries.

Another substantial weakness in the Russian legislative environment which is hampering the application of fundamental legislative acts concerns the backlog in the drafting and approval of ancillary and regulatory tools envisaged by the aforementioned legislative acts. This problem is equally the fault of the legislature and the executive. It is a long-standing problem that is seriously detrimental to the investment climate as it gives rise to new administrative barriers, raises transactional costs, aggravates risk and instability factors, and provides fertile ground for unequal competition and corruption.

Judicial reform is absolutely imperative for the establishment of an effective legal system in Russia, for ensuring proper enforcement of contractual commitments, and for fair competition.

Unless an independent judicial system run by a qualified judiciary is established, unless investigative, procedural and other practices are changed, and unless the public prosecution bodies are placed under the control of the judiciary, it will be pointless to expect the strengthening of incentives to engage in economic activity or an end to the struggle for control over cash flows in favor of fair competition with the improvement in the effectiveness of capital use that this implies. Unless these measures are carried out, Russian legislation, however advanced or perfect it may be, will remain ineffective.

The Russian leadership's recognition of the ineffectiveness of the current judicial system and its lack of independence from the executive, as reflected in the Gref Program and other government-endorsed instruments developed by the Center for Strategic Reform, has reassured investors and the business community that the views of the Russian political and business elite on the role and nature of the three branches of state power have evolved.

The year 2001 saw active preparations for judicial reform. A new Code of Criminal Procedure has been adopted that strips the Office of the Prosecutor General of its supervisory function. The Code also provides for the introduction of jury courts throughout Russia. This measure should alleviate arbitrariness and false accusations in criminal investigations, which is important to the development of business at the micro level, and to the emergence of small and medium enterprises. It should also serve to motivate the population in general towards more active participation in society.

However, the ongoing consolidation of the influence of the executive and structures directly subordinate to the President over all other institutions of state and the private sector led to a crisis within the judiciary last year and to a loss of authority in the eyes of the rest of society. The reputation of the judiciary has been seriously compromised by a number of decisions taken in several regional elections and rulings on disputes over property at joint stock companies.

The highest profile case was that involving the liquidation of TV-6. By formally following the letter of the law, the court effectively demonstrated bias. The executive authorities on the other hand, while formally remaining behind the scenes, by their words, comments and dialog with the contesting parties left not a shadow of a doubt that it was they who played the key role and decided the outcome of the case.

The destructive effect of such practices on the investment climate and on the prestige of the institutions of state cannot be overstated. Macroeconomic stability, low taxation, and declarations of intent to establish a liberal economy and democratic society mean nothing if the authorities manipulate the law, demonstrate bias, and fail to stick to their own commitments.

The system used to enforce court rulings also leaves a lot to be desired. Arbitration courts and courts of general jurisdiction often refuse to recognize foreign arbitration awards, citing the clause on public procedure, which is rarely invoked in foreign courts. Not only is this fallacious practice glaringly at odds with the 1958 New York Convention, of which Russia is a signatory, it also undermines the authority of the Russian judicial system and deprives foreign partners of reasonable guarantees of protection against unscrupulous Russian parties.

Russian legislation saw a number of substantial changes of a liberal nature last year, which lay the grounds for future improvement in the investment climate, give reason for optimism among investors and the business community, and enhance stability. However, the application of the legislation is being hampered by the absence of judicial reform and the visibly increased influence of the Presidency, structures subordinate to

the Presidency, and other executive bodies over public prosecution and the judiciary. The standard of application of the law is unacceptably low, and the judicial system is perceived as cumbersome, under-qualified and lacking independence. The unequal approach taken towards various legal subjects aggravates property risks, undermines confidence in the authorities, and impairs business and investment activity in this country. The lack of progress with regard to legislative and judicial reform is detrimental to the investment climate.

2. Taxes and customs

There is a need to balance the interests and obligations of the State and taxpayers in order to ensure the successful development of the economy and the prevention of further financial crises. Moreover, an effective tax system will require an equal and objective approach to all taxpayers, which calls for the abolition of the numerous exemptions granted to various categories of taxpayers and specific individual taxpayers, plus an improvement in the tax payment and administration procedures, at the very least.

Over the past three years, Russia has achieved significant progress with regard to tax reform and the reduction of the effective fiscal burden on the economy. The tax system has been changed to favor bona fide taxpayers engaged in economic activity on legitimate and legal grounds. The Government's determination to reduce the tax burden further positively reflects investor and business community expectations and will provide an additional incentive for increased business activity, the legalization of the shadow economy, fair competition, better tax collection, an increase in consumer demand, and an increase in gross national savings. Whatever else may be said about it, the new flat rate of personal income tax has had a tangible effect in 2001: labor productivity rose by 3%, while salaries rose by 19%. This is clearly the result of the legalization of at least part of the shadow economy.

The current stable macroeconomic situation, balanced public finances, economic growth, attendant improvement in tax collections and budgetary stability, and relatively high prices for Russian export commodities (critical for tax collection and the economy as a whole at present) make this an ideal time for carrying out tax reform.

In 2001, the Duma adopted new chapters of the Tax Code on the taxation of profit earned by legal entities and the taxation of mineral resource extraction (to replace the law on the renewal of the mineral resource and raw materials base, extraction royalties, and excise duty, thus simplifying the taxation of mineral resource extraction). The pension reform initiative has led to the amendment of the procedure for paying the single social tax. Several other amendments have been adopted that substantially change the structure of taxation in Russia as of January 1, 2002.

One of the most important changes that took effect in 2002 concerns the procedure for taxing profit. The profit tax rate has been reduced from 35% to 24%, a non-exhaustive list of deductible expenses has been drawn up, and the provisions on depreciation have been changed. Thus, the taxable base has been curtailed and the tax rate reduced,

leading to a significant alleviation of the profit tax burden for taxpayers.

With the adoption of Chapter 25 of the Tax Code, taxpayers will be required to use the accrual method to record tax liabilities. Chapter 25 also abolishes the preferential profit tax regime and the investment exemption. These measures will aggravate the business and investment environment for businesses and may temporarily impair economic expansion. Furthermore, given that the State has traditionally been and continues to be an utterly ill-disciplined contracting party, the introduction of the accrual method with regard to profit tax will impair the financial health of businesses that experience delays in settling their invoices, i.e. first and foremost, those that do business with the State.

At the same time, the new provisions on the taxation of profit will enable foreign companies operating in Russia to benefit from the exemptions envisaged by Russia's dual tax treaties, which in certain cases will mean a more advantageous position over Russian companies. For example, foreign representative offices will be permitted to deduct expenses incurred on their behalf by a parent company located abroad.

Moreover, the tax legislation requires further reworking in order to find the optimum tax burden that will encourage processes contributing to the modernization of the economy and to the emergence of new technology-intensive industries.

Despite the reduction in the profit tax rate to 24%, the burden of tax and social fund contributions levied on payroll remains high (up to 35.6%). Thus, it continues to make economic sense for employers to pay salaries using mechanisms that conceal the employee's true income or change the employee's income status: e.g. income is paid from the company's net profit in the form of material assistance or dividends. The result is that employers have no incentive to declare the real income paid to employees, hence depriving the state budget and the pension system of resources. This situation is doubly detrimental to the Russian economy for the fact that high-tech industries, in which payroll constitutes a large proportion of added value, incur a much greater payroll tax burden than less labor-intensive industries if they pay their employees' salaries as required by law. This situation necessitates a more profound look at the tax burden incurred by various industries in order to equalize the competitive playing field across the economy.

One of the more positive amendments to the legislation is the new mechanism for calculating the maximum level of export duty on oil, which enables better tax planning for oil companies.

Another positive change is the reduction in customs duty on imported equipment, including equipment imported under lease agreements. If the procedure and transparent application of these positive amendments are streamlined, we could see a substantial increase in equipment imports under lease agreements. A significant increase in leasing transactions will facilitate an increase in the flow of capital equipment into those sectors of the Russian economy that currently lack working capital.

At the same time, however, the weaknesses that have traditionally impaired legislative

practice with regard to fiscal issues continue to apply. The Ministry for Taxes and Duties is slow in drafting the regulatory framework envisaged by the tax legislation. The Ministry's commentaries on the legislation are open to different interpretations, to the detriment of business interests.

Changes for the better have also taken place with regard to tax administration, changes that have contributed to economic growth and the financial sector's recovery. The curtailment of non-monetary settlements and the increases in industrial and household earnings have enabled the tax authorities to exceed their tax collection targets, thereby leading to a consolidated budget surplus.

There has been an increase in vigilance with regard to taxpayer compliance and the prevention of money laundering, notably through the creation of a financial investigation department within the Ministry of Finance with a brief to detect illegal operations and tax evasion. Provided the fiscal authorities' work is more transparent and free from bias with regard to their treatment of businesses, these measures will increase the incentive for the shadow economy to become legal, which will level the competitive playing field for all.

Changes are being introduced with regard to foreign trade with a view to alleviating the operational costs borne by tax agents and supervisory bodies, and enhancing control over foreign trade activity.

The new Statute on the Customs Warehouse Regime, drafted by the State Customs Committee in light of the International Convention on the Simplification & Harmonization of Customs Procedures, has been enacted. The Statute sets forth clear provisions on the procedure for applying to establish a customs warehouse and obtaining the required license, and also provides for the transfer of rights with regard to goods held under the customs warehouse regime.

The Government plans to introduce a new information system in 2002 that will enable businesses to track customs clearance procedures in order to prevent abuse and false declarations. Goods subject to the minimum import duty (5%) will be more closely scrutinized in order to combat "gray" imports that take advantage of the lowest rate to import goods subject to higher rates of customs duty.

Besides having a fiscal function, any customs system must also serve as an instrument of economic regulation by protecting domestic manufacturers and creating conditions conducive to import activities. This will encourage competition and force manufacturers to focus on improving quality. This means that the State Customs Committee must adopt a considered and balanced approach to how it operates and how it establishes customs duty rates. Looking at it from that perspective, the customs system has not yet become an effective economic policy instrument.

The State Customs Committee's processes are hopelessly outdated and its technical resources are primitive. This prevents a qualitative improvement in transparency and performance, and fosters corruption and tax evasion.

On the whole, significant progress has been achieved over the past two years with regard to tax reform in Russia, leading to increased optimism on the part of investors and businesses. Provided the current pace of reform is maintained, the next few years will see the emergence of a tax system that will actively stimulate economic growth and business activity. Since Russian taxpayers have a negative perception of the tax authorities due to bad experiences over the past ten years, it is of utmost importance that rules are followed and declared policies observed (especially those policies that have a positive impact on economic activity and prosperity) in order to win the trust of taxpayers who are unwilling to declare their earnings for fear of extortion on the part of tax officials and a tightening of tax administration rules and conditions, rather than for the reason of concealing their illegal origin. However, there will be little ground for optimism regarding the future of the tax system until structural reform has been instituted and the threat of further financial crises has been averted. Liberalizing the tax legislation is not a guarantee of the effectiveness of the new tax system. There needs to be a qualitative improvement in tax administration, which is currently a substantial cause for concern, and improvements in the protection afforded taxpayers, particularly with regard to customs. The tax administration system continues to have a punitive aspect, and taxpayers do not enjoy equal rights. The inadequate progress made by the Ministry for Taxes and Duties, with regard to the drafting of a regulatory framework to support the federal legislation, continues to hamper businesses and investors

. 3. financial markets and the banking system

The modernization of the banking system has been at the forefront of the Government's economic policy for several years. The past two years have seen a number of positive trends regarding the evolution of the banking system, primarily the surmounting of the consequences of the 1998 crisis, which almost collapsed the entire system. By the end of 2001, the banking system had recovered many of its pre-crisis positions, with total capitalization rising in real terms from US\$12 billion to US\$16 billion. As of November 1, 2001, the consolidated assets of Russian banks had passed RUR 3 trillion, corporate lending had exceeded RUR 1 trillion, and private lending stood at over RUR 90 billion. As of December 1, 2001, total bank deposits stood at RUR 660 billion, of which more than RUR 460 billion (more than US\$15 billion) held on fixed-term deposit can be seen as an investment resource. The first 11 months of 2001 saw the volume of private fixed-term deposits rise by 48%. There has been a radical change in the structure of private ruble-denominated deposits from the point of view of term: an almost five-fold increase in the proportion of deposits placed for terms of 1-3 years. This implies a substantial increase in the volume of long-term investment resources flowing from the general public to banks, and points to a significant recovery of public confidence in the banking system. At the same time, there is no satisfactory mechanism in place to head off a potential future crisis in the banking sector, thus the public remains exposed to the risk of losing money held in banks.

The past two years have seen a notable increase in the use of the Internet by commercial banks. Around 20 of Russia's largest banks now offer customers a facility for paying utilities and telephone bills online and for performing plastic card transactions,

while several banks offer Internet-based currency conversion, comprehensive settlement services and depository transaction facilities, etc.

However, broadly speaking, the Russian banking system remains unequal to the demands placed on it by a modernizing economy. It remains under-capitalized and afflicted by an imbalance between supply and demand for lending resources. Interest rates are also excessively high.

The competitive mechanisms within the banking sector are also ineffective. The majority of Russia's commercial banks are too strongly focused on a limited set of products and clients. Despite the large number of banks in Russia (1,271 as of January 1, 2001), most of them actually function as non-bank credit institutions, and do not compete for most banking products.

Many minor commercial banks are also involved in semi-criminal currency transactions and engage in so-called "hard currency" transactions. They are established with narrow special interests in mind and in no way contribute to the optimal distribution of financial resources throughout the economy. Even the major commercial banks do not serve as the major financiers of the manufacturing sector. Despite the fact that some have quite large lending portfolios, in reality most lending resources (95% as a general rule) go to enterprises within the financial and industrial groups of which they are a part. During the period 1999-2001, the rate of lending to non-financial enterprises grew at approximately the same rate as the M2 growth rate. In other words, despite the collapse in the market for State Treasury Bonds and Federal Loan Bonds, which formerly soaked up a substantial proportion of the country's available financial resources, the banking system has yet to make a significant breakthrough in terms of lending to the manufacturing sector.

Only a few Russian commercial banks conform to the generally accepted international concept of what a commercial bank should be. Moreover, Sberbank is the only Russian bank that can be considered a major bank. That context gives rise to the issue of Sberbank's monopolistic position, and its consequences for that bank's effectiveness.

However, even if Sberbank was divided up, it would unlikely solve the problem. There will be no improvement in the competitive environment within the Russian banking system until other major banks and the banking system as a whole expand (possibly through consolidation). Meanwhile, the disappearance of what is by international standards Russia's only major bank could lead to a reduction in the proportion of the gross national savings held at banks. Notwithstanding, the problem of Sberbank's poor performance remains, and the State, as its principle shareholder (via the Central Bank), will have to tackle this problem sooner or later.

The Russian lending market is impaired by a poor institutional infrastructure. There is an almost total absence of mechanisms for guaranteeing and insuring loan and bond commitments, a total absence of rating agencies, poor information support regarding potential lenders and borrowers, and inadequate methodological support for conducting expert assessments of lending projects.

Russia's commercial banks have adopted peculiar approaches to managing their resources on the various sectors of the financial market. With regard to lending, more importance tends to be placed on personal assurances from the borrower to the lender regarding the repayment of the loan than to the intrinsic characteristics of the project in question. At the same time, Russia's banks react quite adequately to changing circumstances on the lending market, as witnessed by the relatively stable correlation between the effective interest rate on commercial loans and the volume of commercial loans issued.

Banks that have their core operations on the securities market tend to attach greatest importance to the liquidity of the instrument while paying less regard to other investment characteristics such as the issuer's risk rating. This is illustrated by the varying levels of popularity of the various corporate debt instruments traded on MICEX - the majority of that trading forum's bank members tend to value a stock's liquidity above all other criteria. For that reason, the announcement of a bond placement by a RABO-Bank subsidiary to be underwritten by that bank, giving it the highest possible credit rating, failed to attract the interest of market operators.

The Joint Program for the Reform of the Banking Sector, developed by the Government in collaboration with the Central Bank, provides a framework for the development of the banking system over the next five years. However, the measures envisaged by the Program will lead to inertia within the sector and fail to tackle the roots of the instability of the banking system that were so clearly manifested during the 1998 crisis. This aggravates the overall risk factor associated with the Russian economy and increases the cost of investments.

The pace of banking reform must be accelerated, or else the inadequate transformation of the gross national savings into investments will continue to hold back the modernization of the Russian economy. The reform strategy devised by the Russian Association of Entrepreneurs and Industrialists, for example, offers a better response to the tasks facing the banking sector since it will lead to a bigger and more effective banking sector within a shorter period of time.

Overall, 2001 was a very favorable year for the Russian financial market. One of the more important achievements was the appearance of the basic pre-conditions for redirecting financial flows into the manufacturing sector. Major breakthroughs were made in the area of legislative support, and real headway was made in addressing tax and pension reform. There was also a substantial increase in gross national savings.

Last year also saw the establishment of the basic economic foundations for increasing the role of corporate debt instruments in financing the manufacturing sector. For one thing, interest and yield rates fell below the average rate of return within industry, and then fell below those within the broader economy. Second, there was a notable redistribution of financial resources to the manufacturing sector thanks to the appearance of new financing channels, and in particular, the corporate debt market. There was also a substantial shift in bank investment in favor of corporate bond debt, which rose almost five-fold as a proportion of total bank assets during the year. While

the total volume of corporate bond debt rose only slightly, there was a substantial increase in the proportion of corporate debt with a liquid market (so-called "market" debt). Total lending (ruble and foreign currency) was also up, by 50% (according to the Central Bank) in the first ten months of 2001. There was also a substantial increase in private lending, with loans to private borrowers up 100% in the first ten months, as compared to a 38% increase in lending to corporate borrowers.

Nevertheless, the main institutional barriers to the further evolution of the corporate debt market as a source of financing for the manufacturing sector have yet to be overcome. The main institutional barrier continues to be the absence of a system for guaranteeing and insuring bond commitments. Another barrier is the absence of an intelligence and legal system to predict debt defaults on the markets for debt issued by corporations and regional authorities. There is an absence of adequate due diligence mechanisms for lending and bond investment projects. The end of last year saw the first signs of improvement in the institutional situation with regard to rating credit risk when Standard & Poor's established a joint venture with a Russian partner. Despite that, however, the Russian economy continues to lack a proper rating system, and until this and other institutional issues are overcome, the corporate bonds market has little hope of turning into an effective source of financing for the manufacturing sector.

The year 2001 saw a clear manifestation of one of the main factors holding back medium- and long-term lending to manufacturing enterprises: according to the World Bank's Moscow office, the average effective interest rate on loans to the manufacturing sector was -1%. In all preceding years, long-term lending (over one year) only increased if the effective lending rate was positive and growing, and the opposite trend observed last year led to a fall in long-term lending to manufacturing enterprises (long-term ruble and foreign currency corporate loans fell from 29.6% to 26.5% of total lending).

Russian borrowers began to return to the eurobonds market at the end of 2001. In the last three months of last year alone, the Moscow Government, Rosneft, MTS and Gazprombank raised approximately US\$1.2 billion on that market. Yield rates were excessively high, however, at 10-13%, a fact that highlights the need to continue efforts aimed at further reducing the investment risks associated with Russia. Despite the substantial improvements in Russian borrowers' credit ratings last year, those ratings remain too low for the largest long-term investment funds to be tempted to enter the market.

The impact of the crisis on the stock market was finally overcome in 2001. The RTS index regained its pre-crisis level, as did the consolidated market capitalization indicator (over US\$80 billion by the year end), and, more importantly; the market appears to have attained a certain stability. The Russian stock market has regained its 1996-1997 status as the highest performing stock market in the world. The nature of last year's growth was, however, principally different from the boom of 1996-1997, as it took place amid a broad downturn in the majority of the developed and developing markets. Moreover, the Russian market has also proven itself to be independent from other

exogenic factors that have traditionally determined its trends. Specifically, the last quarter of 2001 saw sustained growth amid falling world oil prices. The correlation ratio between Russian business activity indices and those of the leading foreign markets ranged from -0.3 to 0.2 in 2001, which points to a certain measure of independence from the global market environment. By the end of the year, Russia had begun to stake a real claim to financial resources flowing out of countries with unfavorable macroeconomic situations (the Argentine default, for example, led to an intense flow of foreign capital into the Russian financial markets).

Two factors are contributing to the new growth trends on the Russian stock market: the emergence of a substantial domestic investment resource base, and the commencement of reforms in the area of corporate relations. Last year saw a substantial increase in private investment into corporate securities. Corporate investments into equity securities and shares increased at an even faster rate. The Russian Government has broadly approved the new Corporate Governance Code, which is based on international corporate governance standards and is recommended for implementation at Russian enterprises. Despite the non-binding nature of the document, it has already been adopted by a large number of Russian corporations. This fact has not gone unnoticed by foreign investors: following the presentation of the Code, many investors reviewed their portfolios in favor of Russian instruments. While the content of the Code is far from ideal, the very fact that a set of national corporate governance standards now exists has substantially improved the investment climate in Russia.

Last year saw the emergence and rapid development of a new securities market sector - the fixed-term contracts market. The appearance of this sector marks the final phase in the development of a fully-fledged securities market, and offers new scope for risk hedging.

The Government's tax reform initiatives have also contributed to the development of the securities market. While the simplified system of taxation applicable to securities transactions had no substantial impact on the market last year due to its late introduction, it is likely to have a decisive impact in the near future. The new procedures for taxing income on corporate securities (a reduced rate of profit tax, dividend tax down from 12% to 6%, a simplified tax calculation procedure, better scope for offsetting losses per securities transactions, etc.) may become a substantial factor contributing to the effectiveness of stock market investments, and thus attract a new influx of investments, primarily from small-scale investors.

A pension reform initiative was launched at the end of 2001 that is likely to lead to US\$8-14 billion in new investments in the stock markets over the next ten years.

However, it is important that these successes in improving the investment climate should not slow down the reform process. If that happens, there is the danger that investor skepticism may once again give way to irrational euphoria in a context of inadequate progress on reforms aimed at offering better protection to investor rights and alleviating other investment risk factors. Such a turn of events could lead to a new crisis if the reforms that have been launched are not carried through completely.

The Government's priority must be to continue to develop the legal framework regulating the stock market, and ensure a broader coverage of legislative provisions, particularly with regard to the fixed-term contracts market. Various aspects of the investment banking business also need further regulation, including the introduction of new legislation.

The Government also needs to continue its effort to expand the possibilities for investing the gross national savings. The various forms of collective investment instruments that currently exist need to be complemented by mechanisms that will enable private individuals to invest directly on the stock market. To that end, a procedure for the functioning of investment accounts with appropriate incentives for long-term investment is required.

Another important task is that of diversifying the range of investment instruments available on the stock market. Among the priority instruments that need to be introduced are commercial paper (private short-term debt bonds with simplified registration procedures), bonds offered by international financial organizations, and mortgage bonds. Now is also the time to provide Russian investors with access to foreign stock markets. The Government will need to introduce mechanisms that enable the circulation of foreign securities on the Russian market in the form of Russian Depositary Receipts, in addition to eurobonds issued by Russian entities.

The implementation of International Accounting Standards for professional securities market participants is clearly lagging behind. The same appears to be true in the case of mutual investment institutions.

There is a clear need for better measures aimed at turning the securities market into a mechanism for channeling capital into the manufacturing sector. In the first half of 2001, financing raised via securities issues accounted for only 0.1% of the total financing of capital investments. The potential of the market as a source of financing, meanwhile, is many times greater. Therefore, it is important to offer incentives to corporations that might consider entering the stock market, to create a specialized primary market infrastructure, and to establish a system of incentives for professional participants and investors on the primary corporate securities market.

Further work is needed to alleviate various aspects of investment risk. The task of establishing compensation funds has long been outstanding. There is a need for stricter control to protect the interests of clients using the services of professional participants in the securities market.

Another important issue concerns reducing the costs borne by professional market players and investors. This task will require continued deregulation and more active use of self-regulatory measures on the securities market. Licensing and reporting costs for professional participants also need to be reduced and a more active policy position needs to be adopted with regard to promoting competition on the securities market. Unfortunately, there is still too much room for stock exchange operators to overstate prices and too much scope for registrars to abuse their positions. The policy of

promoting better consolidation among professional participants should regard the principle of different capital adequacy requirements depending on the nature of the transaction.

Broadly speaking, 2001 was a good year for the Russian financial market and banking system. The basic groundwork was laid for channeling financial flows into the manufacturing sector. The investment role of the gross national savings was enhanced. However, the banking sector, in its current state, is incapable of substantially increasing lending and reducing the cost of borrowing at the same time. The reform of the financial system, and specifically that of the banking system, needs to be stepped up in order to ensure a successful transition to the modernization phase and to underpin the forthcoming and existing structural reforms.

4. protection of ownership rights and corporate governance

Corporate governance and the protection of ownership rights have been the Achilles' heel of the Russian investment climate for ten years now. Bad corporate governance and the poor level of ownership rights' protection have prevented an inflow of investment into the economy, held back the development of business, and prevented the economy as a whole from becoming more competitive. This state of affairs was mainly the result of such institutional defects as poor application of laws, inadequate corporate legislation, a lack of transparency throughout the economy, and the poor functioning of the judicial system. Meanwhile, the radical changes that took place with regard to ownership in Russia were not accompanied by the development of appropriate corporate governance mechanisms.

In the past years there have been changes for the better that point to a change in attitude on the part of owners and managers at a whole range of Russian companies, and on the part of the State, with regard to the importance of good corporate governance. Companies that are seeking new opportunities for raising financing for internal development have become acutely aware of the relationship between the quality of corporate governance and attitude towards investors, and in particular, attitude towards minority investors.

The issue of enhancing corporate governance and affording an adequate level of protection to ownership rights has been added to the list of priority issues that must be resolved in order to ensure the modernization and structural overhaul of the economy set forth in the Gref Program. The Duma has set up a commission for protecting shareholders' rights. A number of self-regulating investor associations have been set up to protect members' rights, while there have been many examples of shareholders joining forces to fight for their rights (mostly with regard to additional share issues on closed subscription, asset stripping and non-payment of dividends). A number of major companies (YUKOS and RAO UES of Russia) have substantially improved their corporate governance standards and achieved normal relations between managers and shareholders.

The role of boards of directors and the professionalism of their members have come

under close scrutiny in the context of this issue. The FSC's Program for the Improvement of Corporate Governance in Russia is aimed at improving board structures.

In recognition of the need for an overhaul of corporate governance, the Investor Protection Association (IPA) and Ernst & Young announced the launch of the Independent Director Program on October 2, 2001. The Program provides for the creation of a National Independent Directors Association for the purpose of providing support to Russian joint stock companies and enhancing their effectiveness through the use of independent directors. The Association's goal is to establish effective corporate governance and public control mechanisms, and to promote professionalism and ethical standards among independent directors at Russian enterprises.

In 2001, 23 directors from the IPA joined the boards of directors of 38 Russian enterprises. The IPA has already nominated candidate directors to 70 enterprises in 2002.

Last year saw the commencement of work on the creation of a code of corporate conduct, which will serve as a guideline on how best, from the point of view of protecting the rights of shareholders and other stakeholders, to organize the way an organization is run. One such code is being drafted under the supervision of the FSC (to be published in February 2002). However, it is clearly not in the interests of the business community to hand over to the State the task of drafting guidelines on business practices (including corporate governance), and more importantly, for such an instrument to become compulsory. Over-formalization of rules governing the activities of businesses is no less harmful than the absence of any rules. The business community must make a more active contribution to improve corporate governance standards at Russian enterprises by drafting its own code of corporate conduct.

Investor sentiment will be improved by judicial reform, the development of legislation to close the loopholes in bankruptcy laws, the drafting of a law on nationalization setting forth provisions on the amount and conditions of compensation under which the State may renationalize property, and a fixed deadline for reviewing privatization deals.

Amendments have been made to the law "On Joint Stock Companies" aimed at protecting shareholders' rights (particularly those of minorities), which makes managers more accountable to owners, and provides for an increased role for minority shareholders in company operations. These include:

- an amendment that eliminates the need to buy up fractional shares resulting from consolidation. This should help resolve the numerous disputes arising with regard to the consolidation of Russian joint stock company shares;
- an amendment requiring a unanimous decision by the board of directors prior to any additional share issue, replacing the simple majority decision that previously applied. This means that it will be impossible to adopt a decision on an additional share issue if a group of shareholders, with at least one representative on the board, objects;
- an amendment giving preferential share purchase rights to shareholders who have voted against or who have not voted in the event of a closed subscription. This

amendment will make it more difficult to dilute minority holdings;

- an amendment extending the list of documents that a joint stock company is required to maintain and to which shareholders must be afforded access. Henceforth, shareholders jointly controlling at least 25% of the voting shares in a company will have access to accounting documents and to the minutes of meetings of the collective management body.

One of the most important factors that influences investor attitudes of Russian companies is the stereotypical perception of the Russian businessman, which for the majority of foreign investors is unfortunately not favorable. This is illustrated by the fact that a number of start-up companies have felt obliged to conceal their Russian origins when entering Western markets.

The actions of the public prosecutor's offices are drawing the Russian business community into disrepute, particularly their use of inappropriate preventive measures such as holding people in custody when neither the nature of the alleged crime nor the level of danger to society and other people mandates such measures.

Among the factors preventing a qualitative improvement in corporate management is the presence of state structures among company shareholders. Such structures (shareholders) often have ineffective control over their shareholdings and make poor investment decisions. They also lack a balanced management policy. For example, the State is currently entangled in a conflict of interests with regard to RAO UES of Russia, since the State is simultaneously the regulator, primary customer and principle shareholder of this company. State structures owe huge amounts of money to energy companies in many regions. Thus, the principle shareholder of RAO UES of Russia impairs the environment in which the energy operator might otherwise develop and evolve, and harms the investment appeal of the energy sector as a whole.

Representatives of ministries on the board of directors of RAO UES of Russia essentially look after their own conflicting institutional interests (representatives of the Property Ministry demand dividends, members of the Federal Energy Commission establish tariffs, and meanwhile representatives of the Energy Ministry demand a stable and reliable supply of electricity). They are incapable of adopting a coordinated position with regard to the company's development strategy.

The Government's decisions on staffing are to be welcomed in cases whereby they lead to better efficiency and transparency, such as in the case of Gazprom. Unfortunately, however, Gazprom remains the exception rather than the rule.

Another substantial problem deterring investors from entering the Russian market is the current bankruptcy law, which offers ample scope for orchestrated and fake bankruptcies. Indeed, under the provisions set forth in the law, more than 80% of Russia's enterprises effectively qualify as bankrupt. Work is underway at present to amend that law. The Government's draft for the new law envisages the incorporation of financial recovery procedures into bankruptcy proceedings, and provides a detailed description of the procedures to be followed. This will enhance the effectiveness of bankruptcy as a mechanism for improving the efficiency of decisions taken by owners

with regard to their capital.

The slow pace of accounting reform also impairs corporate governance in Russia: compulsory requirements on transparent disclosures would make managers more accountable to shareholders, and thereby contribute to a qualitative improvement in corporate governance standards.

Substantial progress has been made over the past year with regard to legislative support for corporate governance and the protection of ownership rights, thus alleviating certain investment risks and enhancing the quality of enterprise management. It is important and necessary, nevertheless, to eliminate the remaining scope for misappropriation of property that currently exists as a result of loopholes in the bankruptcy legislation, and to enhance the effectiveness of the State as an owner.

5. accounting reform

The issue of accounting reform remains outstanding and in urgent need of resolution. Russian statutory financial statements (which retain many aspects of the financial reporting system of the socialist era) are unsuitable for use in effective decision-making, and are inconsistent with generally accepted standards on the disclosure of information in a market economy. The lack of transparency throughout the economy as a whole, and within individual enterprises, is deterring investment into the manufacturing sector, preventing Russian businesses from entering international capital markets, hampering the development of the financial system, and ultimately, impeding economic growth.

Specifically, it is not possible for banks to establish fully-fledged correspondent relationships with foreign banks without submitting financial statements prepared in accordance with one of the officially recognized international sets of standards [International Accounting Standards (IAS) or US Generally Accepted Accounting Principles (US GAAP)]. Moreover, business entities are being prevented from raising financing on the capital markets by the weaknesses inherent in, and potential inaccuracy of, their Russian statutory financial statements.

Furthermore, the process of globalization makes it increasingly important for all countries involved in economic integration to apply a uniform set of principles to financial reporting. International Accounting Standards (IAS) has received official recognition as the future global standard on the disclosure of financial information from the major multinational corporations. The US Securities & Exchange Commission (SEC), which is playing a direct role in the reorganization of the International Accounting Standards Committee (IASC), has come out clearly in favor of the amalgamation of the two accounting systems: US GAAP and IAS. The International Organization of Securities Commissions (IOSCO) has issued a resolution recommending that the application of IAS should be made a condition for companies to be listed on international securities exchanges, and has already taken a number of tangible steps in that direction.

However, the two-year accounting reform program that was launched in Russia in 1998 has not been completed. Less than 20 out of the required 37 standards have been

drafted. This slow progress is a result of the poor level of commitment on the part of the parties to the project. The decisive role in the development and adoption of accounting standards continues to be played by an inter-agency Government commission in which the Ministry of Finance holds a key position, but which lacks any representation of the business community. Private sector specialists are engaged, at best, in the role of advisors, and have no right to vote in the commission.

This gradual replacement of standards is not the correct approach. It increases the operating costs incurred by businesses and statutory bodies, and distorts the accuracy of reported data. The proper approach would be to immediately implement the entire set of international accounting standards and then draft regulatory instruments and recommendations to allow for specific aspects of the Russian economic environment.

The ongoing development of information technologies and the increasingly advanced qualifications and experience of financial staff at companies operating in Russia, who have coped admirably with the problems brought about by the constant changes to the tax legislation, indicate that accounting reform is something that can be carried out relatively quickly.

The key to reforming the financial reporting system involves drafting a legislative framework that is consistent with the rest of the legislation, complete, transparent, and coherent. This is a task for specialists and does not require substantial capital investment, institutional reorganization, or favorable exogenic circumstances, etc. The speed with which accounting reform is carried out is in many ways determined by the level of Government commitment and the insistency of the business community.

6. reform of the natural monopolies

Reform of the natural monopolies represents the quintessence of the problems that arise in connection with the reform of the Russian economy as a whole. This is partially due to the social and economic importance of these structures and their role as major revenue and expense items for the State budget, the private sector, and individual households. It is no exaggeration to say that RAO UES of Russia, Gazprom, and the Railways Ministry are the three mainstays of the entire Russian economy. These three giants have a tangible influence on how the country's domestic and foreign policies are formed.

Moreover, the economy as a whole has suffered greatly in recent years for the fact that the three natural monopolies have, in many respects, dictated the nature of the State's policy towards them (particularly with regard to tariffs), and benefited from a total lack of transparency and from limited government scrutiny of their activities.

The current need to step up the modernization of the economy throws the issue of a strategy of reform for the natural monopolies into sharp relief. The reform and modernization of RAO UES of Russia, Gazprom and the Railways Ministry is necessary to improve their efficiency, but also to underpin the stability of the economy as a whole, to foster the emergence of a truly competitive environment, to eliminate potential barriers to economic growth (in the form of an under-developed transport and energy

infrastructure and inadequate fuel production), and to safeguard the nation's energy security. The reform of the natural monopolies must not, however, damage other parts of the economy: tariff increases must not be allowed to undermine the financial condition and competitiveness of other industries.

Last year our concern was that the initiative in drafting a framework for the reforms process had been seized by senior officials from the natural monopolies, in light of their tendency towards corporate secrecy and conservatism, and their opposition to fundamental change. International experience shows that the best results in corporate restructuring are achieved by people brought in from outside or by people promoted from within a corporation, rather than by existing management teams.

In that respect last year saw positive change: the leadership at Gazprom and the Railways Ministry was changed (the same changes took place at RAO UES of Russia earlier). However, that in itself does not point to a breakthrough in the reform process at the natural monopolies since the new teams at Gazprom and the Ministry are still occupied with establishing control over their entities (the Railways Ministry saw its top echelons change only at the end of 2001), which objectively takes a certain amount of time, and have yet to propose anything fundamentally new.

RAO UES of Russia has achieved the most progress in terms of reform: a framework has been devised for the reform of the energy sector, and a timeframe has been set. The reform program proposes dividing RAO UES of Russia into several independent companies, fostering competition within the energy sector, shifting to market principles in pricing and operations (separate generating and distribution companies), and more closely scrutinizing activities that are inherently monopolistic (transmission and distribution control). The reform program also contains elements aimed at enhancing the transparency of companies in the energy sector and more effective regulation (the State will no longer be responsible for the economic management of competing sectors of the economy). This is intended to enhance the investment appeal of the industry, which is in dire need of cash. The energy reform process is structured into three phases, each phase is scheduled to take an average of three years.

The management of RAO UES of Russia succeeded in arranging a constructive dialog between the State (its principle shareholder) and minority shareholders in the company, which has resolved most of the disputed issues.

The reform program for the Railways Ministry, which contains considerable input from the former management of that institution, also calls for the separation of the State's regulatory and economic management functions, and is designed to be implemented over three phases through 2010. The first phase will involve fostering a competitive environment in the rail transportation sector, provisioning equal access to railway infrastructure, ongoing privatization, and divesting non-core assets from the federal railway structure. The second stage will see a gradual phasing out of cross-subsidization, the fostering of a competitive environment in the goods and passenger transportation sectors, and a transition to free-pricing in the competitive sectors. The third phase will see the active solicitation of investment through the sale of shares in the subsidiaries of

the open joint stock company Russian Railways and other companies established in the rail sector on the basis of state capital.

However, the pace of the reforms process only begins to increase when it comes to issues that tie in with the corporate interests of the railways monopoly. Specifically, the Ministry has yet to begin its stated policy of divesting itself of enterprises, which are not involved in traffic control or emergency and repair functions and which could become its competitors in the future.

The reform of Gazprom has yet to begin. The Ministry of Energy is planning to submit its conceptual framework for the development of the natural gas market in 2002.

Given the current lack of transparency at the natural monopolies (especially Gazprom and the Railways Ministry), increased capital investment into these entities is no guarantee of enhanced efficiency and best possible development. The reform process is, however, expected to accelerate in 2002, and management efficiency is likely to improve. The State has demonstrated increased interest in the activities of the three monopolies and a tougher policy in their regard. It has slashed their investment programs for 2002 and granted substantially smaller rate increases than those demanded. Despite the short-term negative impact of these measures on the monopolies' financial condition, the Government's stance will provide added stimulus to restructuring processes (provided that the Government is determined to carry through the reform process and foster the emergence of liberal market mechanisms, and provided that the monopolies are kept under close scrutiny).

Another positive development has been the Government's decision to consider raising the natural monopolies' tariffs before, rather than after the drafting of the budget for 2003. This will ensure more accurate inflation predictions, better investment planning for the monopolies, and better business planning throughout the economy as a whole.

At the same time, it is important to note that the plant and equipment of the energy sector is now at a critical level of obsolescence. The natural monopolies' rates on the domestic market are artificially low, with various categories of consumers enjoying cross-subsidization from other categories. The current pricing system offers no incentive to the general public to conserve energy. Moreover, the fact that the natural monopolies essentially subsidize the rest of the economy is depriving them of the investment resources they need to expand their business.

For that reason, reform of natural monopolies (with a view to enhancing operational efficiency, cutting costs, fostering competition where such competition is possible, enhancing their investment appeal, etc.) should not be considered equivalent to general structural reform within the economy. The issue of raising rates is a historical problem that needs to be resolved in order to foster competition throughout the Russian economy as a whole.

Reform of the natural monopolies is one of the keys to the emergence of a competitive market economy in Russia. It is a task of massive proportions that will impact society in

general and the economy as a whole. It is a task in which the interests of elites, business and government cross paths. Reform of the natural monopolies is essential, and it is equally essential that it commence as soon as possible.

Conclusion

Russia is standing on the threshold of major changes, at a new crossroads in her destiny. The strategy we elect to follow now will determine the irreversible course of events to come. Either our country will join the civilized Western world as an independent, fully-fledged, mature body politic running a competitive economy supervised by an effective state, or else it will slip into a state of abject poverty and utter backwardness.

We are faced with the task of modernizing the economy, a strategic task of monumental proportions that will determine our role in the global community for a long time to come. We are essentially faced with the task of changing our approach of how we run our economy, both in the public and private sector, how we make our decisions and how we ensure they are carried out. That will require significant changes in the people who run the economy, changes in the way we organize our work, changes in the systems and methods we use to benchmark and control efficiency, as well as better transparency in business and better access to information and information technologies.

Given the extremely volatile nature of the external environment over the past ten years (the onset of the transition period accompanied by macroeconomic instability and radical changes in accepted conventions in many areas of activity and life), Russian managers have been obliged to focus on short-term issues such as profits and losses in the immediate term. Although this was unavoidable, it has resulted in a "legal nihilism" of sorts within the general public, whereby the prestige of the law and the authority of custom and formal and informal conventions have fallen sharply. The level of mutual trust between the State, business, the general public and individual people is extremely low.

Russian society is faced with the task of changing its attitudes towards rules that govern various areas of activity. That can only be achieved through conscious effort, through due consideration of the interests and views of opponents, and with the goodwill and patience of all concerned: the government, the business community and the general public. It is a process that demands the clear definition, delineation and enforcement of the rights and obligations of all parties: Society as a whole, the State, and business.

The evolution of law and the public attitude to law is an indicator of the level of a society's advancement. It determines the level of readiness to deal with issues that need tackling, and the complexity of those issues in view of their long-term consequences for the future of that society and possible losses for the people.

The forthcoming modernization of the economy is a task of mammoth proportions that will require the maximum deployment of all of the resources available to the economy, including intellectual resources. It is imperative to foster the institutions of democracy so

that the entire society is involved in the decision-making processes and is conscious of its democratic responsibility for the choices it makes. That will not be possible without the emergence of the institutions of civil society and a strong and independent mass media. Such an outcome is only possible in a democratic system of government in which freedom of speech reigns. No better way has yet been invented.

ENDNOTES

The year 2001 was characterized by industry-to-industry capital flows, e.g. investments made by certain industrial and financial groups in the farming, consumer goods and food sectors. Oil and metal industry capital continues to flow into the manufacturing sector. However, these capital flows have been largely bypassing established financial markets. Methods used to take over property can hardly be called civilized.

² Review by the Development Center, December 24, 2001, www.dcenter.ru

³ A. Belousov. In anticipation of the \"Russian Miracle\" (the Results of Post-crisis Growth and Prospects for the Nearest Future). <http://www.forecast.ru/>

⁴ According to the discussion of current public service reform by the Liberal Mission Foundation, December 2001, www.liberal.ru

⁵ Domestic electricity, gas and rail tariffs are significantly lower than similar rates in other countries.

⁶ Russian metal exporters believe that the existing restrictions on the import of certain metal products from Russia are designed to protect US manufacturers. Therefore, Russia should be taken off the list of nations subject to additional import restrictions, in accordance with Article 201 of the 1974 Trade Act.

⁷ First and foremost, WTO member states oppose the existing pricing mechanisms for energy monopoly services such as RAO UES and Gazprom, because low energy tariffs effectively subsidize Russian companies and provide an unfair competitive edge to them. Further claims are voiced over protectionist methods and remedies seeking to protect domestic markets from foreign manufacturers and businesses by high import duties.

⁸ In October 2001, international rating agency Fitch IBCA Duff and Phelps (Fitch Ratings since January 2002) raised Russia's credit rating to A+ with stable forecasts. In November 2001, Moody's upgraded Russia's credit rating to Ba3 (equal to BB- by Fitch and Standard & Poor's). In December 2001, Standard & Poor's also raised Russia's long-term sovereign domestic and foreign currency credit ratings from A to A+.

⁹ According to the Economic Expert Group, capital outflow dropped to 7-8% of GDP in

2001 against 10% of GDP in previous years.

¹⁰ In this case, the \"non-market sector\" concept differs from the concept which is used, for example, in the national account system (NAS) and implies that this category includes designated market economy agents who do not bring any economic benefits due to a protracted period of adaptation to new conditions in Russia's emerging market economy or other reasons, e.g. those agents who generate negative added value.

¹¹ The 1999 McKinsey Global Institution report on Russia, which described labor productivity in certain sectors of the Russian industry, showed that productivity in certain sectors was much lower than in the US.

¹² Economic Analysis Bureau. Information and Analysis Bulletin No. 28, <http://www.beafnd.org/russian/activity/library/bulletin.htm>

¹³ The major investor nations, which have invested on an ongoing basis, include Germany, the United States, Cyprus, France, the United Kingdom, the Netherlands and Italy.

¹⁴ In July 2001, FITCH raised Russia's projected credit rating from stable to positive (Â). In December 2001, Standard & Poor's also improved Russia's long-term sovereign domestic and foreign currency credit ratings from Â to Â+.

¹⁵ Adopting the law on the electronic digital signature is one of the conditions that Russia must meet to accede to the WTO.

¹⁶ In the course of negotiations over recent years, certain countries indicated that Russia has not met the conditions necessary for WTO accession. In particular, the Russian legislation (above all, the laws on customs regulation, standardization and certification) not only fails to meet WTO criteria, but is not enforced.

¹⁷ The liquidation decision was adopted based on a minority shareholder's lawsuit on the basis that the company's assets in 1998-2000 were lower than the statutory minimum amount of charter capital. This verdict was later approved by a court of appeal which established a six-month term for completing liquidation proceedings. A court of cassation then abolished the liquidation verdict and submitted the case for new hearings, triggering an appeal filed by the plaintiff to a court of higher authority. The promptness of judges who made the decision in favor of the plaintiff implies that the decision was a politically biased one, despite formal compliance with the law. Re-consideration of the case appears unlikely: the article, which was relied upon by courts in deciding to liquidate TV-6, no longer exists; therefore, the confirmation of the decision, which was adopted only a few days before the abolition of the article, was only designed to liquidate TV-6.

¹⁸ Judging from the last few years, the overall tax burden in the Russian economy

stands currently at some 30-35% of GDP (including contributions to non-budgetary funds), and any significant extra burden gives rise to increased tax arrears and proliferation of tax evasion schemes. Transitional Market Economy Institute. \"Problems of the Russian Tax System: Theory, Experience, Reform\". V. 1, p. 9.

¹⁹ Chapter 25 of the Tax Code.

²⁰ There are plans to reform property-based taxes and payments for natural resources and to introduce a uniform agricultural tax in 2002. It is envisaged to preserve sales tax during 2002-2003. Beginning from 2004, it will be abolished.

²¹ The procedure, which existed to date, included an open-ended list of income whereby virtually all items of a taxpayer's income were subject to tax, and an exhaustive list of expenses prescribed by the Statute Concerning the Composition of Expenditures, which did not include all unavoidable expenses. In the new law, the list of income is still open-ended, but the list of expenses becomes non-exhaustive as well. Expenses subject to statutory limits now include only entertainment expenses, certain advertising expenses and payments of interest on bank loans. A new mechanism of asset depreciation for tax purposes is introduced, with the declining-balance method added to the straight-line method.

²² Judging from the experience of other countries, tax exemptions, which are expected to fuel investment processes, do not always trigger anticipated results. A more important role must be played by other factors such as the extent of entry/exit barriers and macro-economic stability, etc. Exemptions undermine fair competition and obstruct its development because companies which are already present on the market have a more favorable position compared with new entrants who do not have any profit and, consequently, face a higher tax burden. However, exemptions make tax administration more complicated, reduce budget revenue and encourage tax evasion instead of using tax savings for investment purposes.

²³ In the case of \"gray\" import, the products of multinational and Russian companies cannot compete with products which are imported illegally at prices lower than those of manufacturers because many imported products which are not subject to import duties are much cheaper than domestically made products or legally imported goods. Evasion from customs duties also reduces state revenue from foreign trade and triggers the selection of business entities on the basis of negative criteria.

²⁴ Sberbank accounts for a lion's share of individual deposits (as of October 1, 2001, individual deposits at Sberbank amounted to RUR 440 billion). As of October 1, 2001, its net assets totaled RUR 60 billion.

²⁵ The Code envisages the drafting of standard proceedings for the bodies of joint stock companies in the summer of 2002, and a meeting of the corporate governance steering council is scheduled for September. The Federal Securities Commission has received

letters from more than 20 major Russian joint stock companies which have already implemented the provisions of the corporate governance code before its enactment in February 2002, and 70 support letters from governors. The FSC expects massive disclosure of data on compliance with the Code's provisions in 2003.

²⁶ Review issued by the Development Center on December 24, 2001, www.dcenter.ru

²⁷ State agencies, above all, the Ministry of Finance, believe that Russian Accounting Standards are being developed in accordance with IAS and that the key task is to ensure their phased implementation. Auditing and advisory firms face a significant demand for their services fueled by the existence of two different sets of standards and the need of translating financial statements from one format to the other. Businesses, primarily those companies which have to maintain their accounting records under both domestic and international standards, are the only community which is effectively interested in reducing the timeframe for IAS transition. In other words, the most competitive Russian entities which are of interest for investors and are creditworthy incur double expenditures to compile their financial statements.

²⁸ In particular, according to effective Russian Accounting Statutes (PBUs), there is a group of "low-value and short-life items" which is absent in IAS. Also, they are based on different principles of asset valuation, depreciation and impairment, and the problem of high inflation (as well as hyperinflation) is ignored.

²⁹ For example, at present *Konsultant Plus* delivers CD-ROMs with updated legislation to approximately 100,000 offices weekly. Many companies now have sufficient financial resources to secure the delivery of new legislation to all need-to-know users within two weeks.

Exhibit 15

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Bankers note successes, call for more work Good news and bad at Russian banking conference in London

By DENIS BYSTROV / Special to The Russia Journal

LONDON – Prominent bankers flocked to an international conference on the Russian banking sector in the British capital this week, which observers say revealed the full promise of the Russian market.

But despite high levels of interest, most London financiers at the conference said they were still cautious about investing in Russian assets.

Western financiers named Sberbank's de facto monopoly, the negative role of state-owned banks in general and the still widespread practice of lending without having the resources to back the loan as negative factors. "Russia has one of the highest risk ratings for its banking sector," said Scott Bugie, a leading analyst at Standard&Poor's.

Speaking at the conference, which was organized by the Adam Smith Institute, Deputy Finance Minister Sergei Shatalov optimistically said that Russia's macroeconomic indicators would be better next year than this year. In 1999, for example, inflation was 36.5 percent, in 2000 it was 20.5 percent, this year it won't be more than 18.5 percent and the forecast for next year is 11-13 percent.

These inflation forecasts take into account an increase in natural monopoly rates of 20-40 percent. But even an increase of this scale won't affect the ruble's stability – the natural monopoly rate increase will raise inflation by at most 3 percentage points. Shatalov also said that the tax on buying foreign currency would be abolished next year and the cash market would become more liquid and more open.

Head of the Federal Securities Commission Igor Kostikov painted an equally positive picture of Russia's finances. Kostikov told the conference how President Vladimir Putin had signed a decree on public companies that would come into force in August 2002. The decree will make some revolutionary changes in the market. It improves protection of shareholders' rights concerning additional equity issues and dilution of capital, and also as regards consolidation of companies.

But not all the Russian representatives shared the authorities' optimism. Alfa Bank President Pyotr Aven said that Russian financial indicators were looking good and that there's no reason to expect a banking crisis. But he also didn't see prospects for foreign investment flowing in. Aven said that banks had to drive investment, and in this respect he predicted difficulties. "Only 3 percent of financing that gets invested in Russian companies comes from Russian banks," he said.

Head of the Duma's budget committee Alexander Shokhin said it was essential to solve two other issues – withdrawal of the state from state-owned banks' capital, and introduction of guarantees for household deposits. The Central Bank currently participates in the capital of almost 400 banks, while the government is a shareholder in some three dozen banks. Shokhin said he couldn't understand why the Central Bank guaranteed only deposits in Sberbank. He also said that banks with state participation had a stifling effect on competition in the sector.

Responding to these reproaches, President of Sberbank Andrei Kazmin said that Sberbank isn't trying to cling to its unique advantages. Kazmin pointed out that the deposits' market is growing, that Sberbank's share is declining, and that this is a normal process. Kazmin said he understood the need for a special program to develop commercial banks with a widespread branch network, and said that without the state's support, banks wouldn't solve these problems themselves.

First Deputy Chairman of Vneshtorgbank Anatoly Nosko raised the question of who would participate in banks' capital if the state pulled out. He said it was possible that if the Central Bank pulled out of Vneshtorgbank, 100 percent of the bank's shares might be transferred to the government. "This has no relation to liberal reform," he said.

Nosko said that if the Central Bank withdrew from banks' capital, it should be in order to have them privatized, not nationalized. Nosko said he preferred the idea that the European Bank for Reconstruction and Development (EBRD) should become a shareholder in Vneshtorgbank. This, he said, wouldn't go against the principles of privatization and would be in keeping with international standards.

The banking specialists had different views on future prospects for the Russian banking sector. The gulf between state and commercial banks was seen as a negative factor. Sberbank and Vneshtorgbank are way in the lead, while Russia's strongest 20-30 commercial banks are still too weak to grow dynamically on their own and compete with the state banks.

Hubert Pandza, head of Deutsche Bank's Russian office, said that Russia's banking system was lagging behind that even of its neighbors. In Poland, foreign capital makes up 70 percent of the banking system, while in Russia, it is no more than 7 percent. Kazakhstan has gone a lot further than Russia in stabilizing national finances and creating a modern pension system. Banks giving out loans without having adequate reserves to back them is still a problem in all the C.I.S. countries. This creates the risk of a banking crisis caused by bad loans.

But head of ABN AMRO's Russian department, Nicholas Haggerty, called on his colleagues to be more objective about opportunities for work in Russia. "Western investors only have themselves to blame for losing money in Russia in 1998," he said. "We should admit that Russian banks are better at handling the risks of their market than are experienced Western banks. We shouldn't look down on them then and lecture them on how to do business. Foreign financiers have to think themselves about how to become creditors on the Russian market and how to insure themselves from potential losses."

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Exhibit 16

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News & Analysis Weekly

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Vol.5, No.2 (145)

State not ready to pull out of pocket banks

By EKATERINA LARINA / The Russia Journal

A government commission that has spent more than a year carrying out an inventory of state banking assets presented a report last week that analysts say suggests the state has no immediate plans to divest its holdings in the sector.

The report proposed that the state sell its holdings in seven banks, but analysts say that so far the government looks to have avoided spending time and effort breaking down the resistance of bureaucrats determined to hold on to their "pocket banks."

"Judging by the information we have, it doesn't look like they're going to pull out of anything," said Oleg Vyugin, deputy president of Troika Dialog. "These seven banks that the state is supposedly going to withdraw from – this is nonsense, it's not even worth serious discussion."

The commission had no choice but to present a report on its work sooner or later, in large part because the idea came from President Vladimir Putin himself. Just after he was elected president, he ordered the government to carry out an inventory of state-owned assets in the banking sector and report on the expediency of the state owning this or that asset.

The report presented to the government, which amounts to a draft report to the president, contains statistics on state participation in the banking sector, analyzes the extent and sense of state participation and makes proposals for shedding nonessential assets. This latter category includes seven banks from a list of 40 banks in which the commission says the state's stake is higher than 25 percent.

Chairman of MDM Bank Andrei Melnichenko said the most logical thing to do would be to classify state-owned banking assets according to three categories: first, banks in which the Central Bank holds a stake; second, banks owned by the government itself; and third, banks with stakes held by various government agencies and state-owned enterprises.

"The third group is the biggest and makes the least sense," Melnichenko said. "At the moment, this category includes around 500 micro-banks, and no one can give any coherent explanation as to why they're needed."

The report puts state participation at 32.8 percent in the 40 banks in which the state holds more than a 25 percent stake. Sberbank and Vneshtorgbank account for most of this state participation. If these two banks are not counted, the state share in the 40 banks' capital falls to 5.17 percent.

Troika Dialog's Vyugin, who is a former first deputy finance minister, said a clear distinction should be drawn between the different types of banking assets in each case. Vyugin said the real problem lay with the large banks, especially Sberbank, rather than with the small "pocket banks," which he called more of a "moral problem."

"The real damage comes from the monopolists, the big banks like Sberbank and Vneshtorgbank," Vyugin said. "The Central Bank helped them with capital, and conditions that are unfair from the outset are an obstacle to developing a normal competitive environment. As for the rest, it's more of a moral problem. The state isn't spending anything on them now, but all these 'pocket banks' were set up with state money, and the state never got anything back."

"Many large corporations have 'pocket banks,'" Vyugin said. "Not just because the banking system is ineffective, but also because there are various operations that it is better 'outsiders' don't know about."

MDM Bank's Melnichenko said there is a purely human factor involved – the wish to have something to fall back on if need be – and then there is also plain old theft.

✓ "It's some kind of mass idiocy when people are always putting money into something and getting no profit from it," Melnichenko said. "Obviously, there's some other motive involved. I think that motive is common theft."

"I can't think of an example of the director of a sports or cultural institution or a transport company suddenly launching into successful investment activities," Melnichenko said. "But I have seen figures that show how much the state has put in and how much it has gotten back."

Melnichenko said it was time something was done about this situation and cited the example of Konversbank, which worked with the Atomic Industry Ministry. Over a period of 11 years, the bank received investment totaling more than \$100 million and gave dividends of only \$600,000.

Effort would have to be made to overcome open and hidden resistance from people linked to these banks, Melnichenko said, and suggested the best solution would be to be decisive. "The state should simply take all its banking assets and put them in one place," he said.

✓ "They [the heads of government agencies and companies owned fully or in part by the state] will fight to the last," Melnichenko said. "They will raise objections, but it can't make things any worse. So there won't be any dividends, but there aren't any anyway, so it's not going to make things worse. Then [the state] has to take a close look at everything – there might be something useful there. If there is, find a manager who will run it competently, if not – let the state sell."

✓ A source in the government suggested the commission had already run up against resistance. As well as various arguments in favor of why a bank should stay in state hands, opponents of the privatization idea say it is legally up to the head of state-owned enterprises to decide the fates of the banks they own.

Vyugin said this argument does not hold water, since the heads of these companies are themselves state employees and are therefore obliged to obey orders from above, or else run the risk of being fired.

"It's obvious that trying to sort out all these banking assets is a troublesome and not very interesting business," Vyugin said. "The commission's results so far are indirect confirmation that the government has decided to put it all off."

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Exhibit 17

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Vol.4, No.47 (140)

BANKING IN RUSSIA: Nascent local capital market hamstrung by negative economic, legislative factors

By KRZYSZTOF CYGIELSKI / Special to Banking in Russia

The relatively undeveloped state of Russia's capital market highlights the acute problems of raising capital or increasing liquidity on the local market, according to sector experts.

✓ Inadequate legislation, numerous restrictive measures, an archaic banking system in need of urgent reform and several other negative factors have all combined to make the local financial market unattractive to most strategic investors, thus limiting the inflow of foreign capital into the economy.

Setting off a chain reaction, the unattractive nature of the market often amplifies such problems as capital flight or the unwillingness to bring capital to Russia from abroad for investment purposes.

Local business moguls often whisk their hard-earned (or illegally acquired) capital out of the country as soon as their multi-million-dollar deals are concluded, while key strategic investors such as George Soros and others are still smarting from losses incurred during the 1998 financial crisis, when they watched their billion-dollar investment portfolios turn into white elephant projects overnight or were outsmarted by local businessmen during Russia's "wild capitalism" period of privatization.

"Most of the foreign investors are sentimental people and, having lost billions of dollars here once, they have yet to be convinced that the current local market's risk/reward capability is ripe enough to warrant making another financial commitment," said Patricia Cloherty, board chairwoman of the U.S.-Russia Investment Fund, which manages \$440 million disbursed by the U.S. government to support business and mortgage issues in Russia.

Capital generally moves freely to markets with lower risks and higher reward levels, and the local capital market does not meet this definition at the moment, she noted.

Attracting foreign capital into the country for real-estate projects has been virtually impossible, partly due to the high risk level perceived by the foreign investment community, said Gerald Gage, head of real-estate consulting at Arthur Andersen's Moscow office.

Peter Westin, a senior economist with ATON Brokerage, shares the view. "The local financial market is currently dominated by small and very often illiquid stocks with the oil majors as the key players, thus prompting most investors to view Russia as an oil play at the moment," he said.

However, most experts agree that the financial crisis did have some positive effects on the market.

While Cloherty conceded that the crisis weaned the market of financial speculators – thus paving way for the traditional investors interested in making long-term strategic investments – Westin contended that the crisis gave key players time to regroup and reassess the relationship between risks and rewards.

Another factor limiting development of the local capital market is that most of the financial instruments used on international capital markets to raise funds are either nonexistent or are only in the nascent stage, with the legacy of speculation-driven activities still prevalent on the local market, experts added.

Consequently, more than 80 percent of local companies are experiencing extreme difficulties in raising or accumulating operating capital on the financial market.

For example, as far as real estate is concerned, the capital market is either limited or nonexistent, key real-estate market experts said.

The Moscow-based International Financial Corp. Bank said that it has been contracted by the Federal Mortgage Agency to act as the financial consultant as well as the organizer of the first agency in the country to emit mortgage-backed securities.

"The plan to lay this foundation for such a vital financial instrument, which is used on developed capital markets to attract strategic investors through stock markets, is a positive step in the right direction," said Olga Sovrelia, managing director of Paritet, a leading local agency on mortgage issues.

✓ "The traditional sources of capital for major investment projects such as pension funds, insurance company reserves, bank funds from long-term savings and investment funds with long-term secured debt objectives have not been sufficiently developed in Russia, either because the capital situation in the country has been so constrained with huge government borrowing, unstable currency or because of restrictive legislation in the past decade," Gaige added.

Real estate requires large bites of capital for relatively long periods – 10 years or more – and currently this market lacks capital pools with these characteristics. What is available is limited to relatively small amounts from local banks or private entities, and only for short terms – three years or less – he added.

✓ The archaic banking sector – which continues to remain mostly a vestige of the communist financial system, with the hegemony of Sberbank remaining largely unchallenged – is another major hindrance to the development of the local capital market, as all efforts at reforming the sector have been blocked by interested parties, including the Central Bank, insiders said.

✓ Sberbank controls up to 80 percent of the retail credit market segment, compared with about 4 percent controlled by Alfa Bank, the second biggest operator in the sector. This trend highlights the monopolist stature of the former in the sector, said Andrei Ivanov, a banking analyst at Troika Dialog.

✓ "Most of the numerous local banks are not yet operating as bona fide financial intermediaries between savers and investors," Westin noted, adding that "some of them are not really banks per se, but financial departments of the local financial and industrial groups and their companies."

Consequently, the level of intermediation of the local banking system as measured by loans as a percentage of the GDP at 12 percent pales in comparison with that of other emerging countries, which is two to five times higher, according to Kim Iskyan, a banking analyst at Renaissance Capital.

✓ The absence of the notion of moral hazard in Russia's banking system, the high level of collusion between the government and banks, systemic opaqueness and perennially fudged numbers have coalesced over the past few years to lay the foundation for stagnation in the sector, he added.

Arthur Andersen's Gaige called for sweeping reforms not only in the financial system, but also in the legislative sphere.

"Attempts to revive the market will require the development of appropriate legislation such as securities laws, tax laws and other regulations necessary to stimulate pooling of capital, and comprehensive reform of the banking system to restore the depositors' and savers' confidence in the system," he said.

The removal of bank shares from the books of the Central Bank is paramount to the success of any proposed banking reform, as it is inappropriate for a regulator to have shares in the entities that it is supposed to regulate, he added.

All the experts, however, concede that the situation on the local capital market is not yet beyond repair, as recent government actions in the sector and the economy in general lend credence to palpable optimism.

"The process to overcome these inadequacies on the market is already under way with a demonstrated movement toward rational economic reform, encouragement of free markets and reduction of risk through provisions for protection of investors' rights," Gaige said.

However, to improve market conditions, the government still needs to curb bureaucracy, reduce corruption and demonstrate a record of transparency and predictability for investment results. And much can be accomplished through legal reforms, and more importantly, their enforcement, experts said.

Secondly, all efforts should be made to maximally diversify the economy in order to create an environment for the emergence of new securities outside the oil/energy sector, insiders urged.

This is strategically important to avoid the local equity market being continuously dominated by the oil stocks and, subsequently, held hostage to world market oil prices as is evident today by the fluctuating oil prices, experts added.

Also, they said, further liberalization of capital movement and removal of the exchange-rate restrictions will help to boost activities on the local market.

"A conducive economic environment coupled with business-friendly legislation, and not the proposed amnesty for return of flight capital, should be seen as the panacea to the general issue of capital flight in the country," Westin added.

"These conditions are now improving and we are beginning to see the development of some capital pools that will provide a source for investment in Russia in the future, Gaige said, adding that "the necessary enabling legislation in the form of securities laws, tax laws and banking reform will be forthcoming to further support the development of the capital market."

(The author is a Moscow-based freelance writer.)

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Exhibit 18



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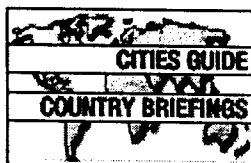
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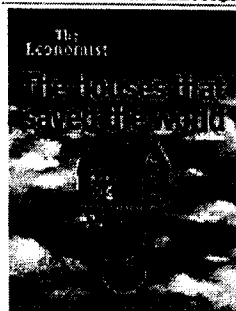
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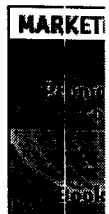
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Viktor Gerashchenko's replacement must surely be an improvement on "the worst central banker in history"
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THE single biggest obstacle to the development of a proper banking system in Russia was probably Viktor Gerashchenko, a wily Soviet-era relic whose second term as head of the central bank ended abruptly on March 16th. His first stint there, in the early 1990s, was marked by financial illiteracy and inflation. Jeffrey Sachs, an American economist, dubbed him "the worst central banker in history". Now, this dinosaur's departure marks an important step on the slow evolutionary path of Russia's financial system.

In past years the central bank has become a byword for pedantic but ineffective regulation, burdening the law-abiding with pointless paperwork and turning a blind eye to the atrocious behaviour of the well-connected. Its other activities have been equally startling. It runs a web of foreign subsidiaries whose purpose is often murky. One of these, based in Jersey, was an energetic speculator in Russian government debt, until Russia's financial crash of 1998. The debt market was run, conveniently, by the bank itself. The bank lied to the International Monetary Fund about the size of its reserves, earning a rare public wiggling. Not all of this happened on Mr Gerashchenko's watch, but he showed no enthusiasm for transparency before or since. One of the biggest financial mysteries in Russia is the size and nature of the bank's precious-metals stockpile.



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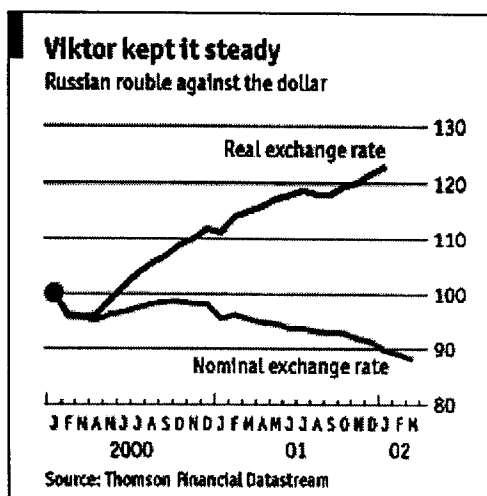
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Internal housekeeping is just as idiosyncratic. The bank employs 80,000 people, highly paid and mostly underworked. America's Federal Reserve system, by contrast, has about 23,000 (albeit for a narrower range of tasks). Unlike its foreign counterparts, Russia's central bank runs businesses, including a large property empire. There is a big pension fund, managed on misty but generous principles.

Taking over all this is a junior finance minister called Sergei Ignatiev. The main claim to fame of this reassuringly colourless figure is that he is widely regarded as honest—a rare distinction among Russia's elite. Mr Ignatiev's shabby suits, old-fashioned glasses, and austere tastes have left a lasting impression on outsiders who have dealt with him. Yevgenia Albats, an investigative journalist now living in America, recalls: "He is a very, very honest guy. I kept asking why he didn't take bribes. His answer was: 'I just cannot. I will feel bad.'"

Mr Ignatiev faces three main tasks. The easiest, for the time being, is macroeconomic. Mr Gerashchenko's main success was to keep the rouble stable against the dollar, in nominal terms (see chart). That stability was probably the single biggest benefit of the past three years. High oil prices and a big devaluation in 1998 have generated a huge trade surplus. This is falling slowly as the underlying uncompetitiveness of Russian industry re-emerges, but it is not an immediate problem for the central bank. Inflation is declining. A more active monetary policy, focusing on interest rates rather than on bullying the currency markets, would be a step forward.



The second task is to manage the bank better. Mr Ignatiev's job will be to replace the bank's crude clout, and reputation for greed, with a new respect for it as an independent institution. That will mean working with the government on reform, while retaining independence on day-to-day decisions. No state institution in Russia has so far managed that.

Trickiest of all is reforming the banking system. The lack of financial intermediation is probably Russia's single biggest economic weakness. Russian banks tend to be small, badly run, and do little deposit-taking and lending. Many are no more than treasury departments for large companies, for channelling money offshore. Some are heavily involved in organised crime. Most Russians keep their savings in hard cash.

Lifting exchange controls would be a tonic for the bank and the economy too: they fail to prevent capital flight of over \$10 billion a year and are rich soil for corruption. Mr Ignatiev says he wants them removed, but slowly.

Sorting all this out will be difficult. Bad banks must be closed: that means taking on some of the nastiest people in Russia. Confronting powerful criminals is possible these days, at least if you have Kremlin backing. It is already under way in the energy industry, where some

notorious figures are facing jail terms. But it will be nerve-wracking and time-consuming.

At the same time, honest banks need more flexible and sensible rules. Making electronically stored data legally acceptable would be a start; so would simply changing the rules on how cash is handled in a bank branch.

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Lombard Street Research Monthly Economic Review

February 5, 2002

SECTION: Comment & Analysis; Statistics; Forecast; Pg. 4

LENGTH: 8036 words

HEADLINE: China and **Russia** pick up the baton from the West

BODY:

The market-savvy face of a new China appeals to everyone. Since the 1978 economic reforms, the country has made tremendous progress. Real GDP growth averaged more than 9.5% a year, leaving China the sixth largest economy in the world in 2001. Per capita income has more than quadrupled in the last twenty years. Foreign direct investment has flooded in and China now ranks in the top five countries in terms of foreign capital inflows. The economy weathered the world economic downturn last year and expanded by 7.3%, faster than any major country. More importantly, its long-term growth potential, estimated at up to 10% per annum, is probably the highest in the world. High savings to GDP and investment to GDP ratios, coupled with ample room for catch-up growth and substantial openness of the economy, should ensure spectacular economic performance in the next twenty years. However, the old plan-economy side of China continues to exist and provides tangible constraints. The institutional and political structure of the economy remains the main drag on development and the source of substantial risk when economic expansion breaches the limitations set by the current political regime. Look no further than Japan. After nearly four decades of impressive capital-intensive, export-led economic expansion, Japan entered a decade of meagre growth with institutional and political paralysis bringing Japanese potential output growth down to around 1.25%. It is very difficult to determine exactly what could trigger a crisis situation in China, and the comparison with Japan is much too generalised to give insights. Thorough institutional realignment with market economies has been expressed as a priority of the Communist government. But the resulting change could easily get out of hand and is almost certainly incompatible with the current political system. One possible scenario is that the limit could be reached when high unemployment as a consequence of structural change leads to social unrest. When analysing China in the short-term, one should also be aware of the shortcomings of its dual economic system. Financial breakdown, arising from a bank system plagued by bad loans (unofficially believed to be 50% of GDP), could also spell trouble. But at this point in time it is more likely to result in lower growth than in any major change in the political set-up.

China started transition as an agrarian economy. Agriculture accounted for almost 40% of GDP at the end of 1970s and no less than 70% of the labour force were farmers. The rapid liberalisation of the agricultural sector, coupled with the more gradual integration into world trade fuelled the primarily export-led, labour-intensive growth. But in effect two parallel structures coexisted - a non-state and a state sector. The non-state sector has up to now been operating without threatening the development or status of the state sector. It is

a wave of mergers and acquisitions as cash-rich oil groups buy up undervalued industrial assets. But this only reaffirms the creation of a Russian style of the "crony capitalism" that plagued the corporate structure of the East Asian economies. Having such a structure of big conglomerates with corporate insiders that put personal interests and size in front of profit, is bad news for the country's long-term productive potential. In the future that set-up could lead to the piling up of so much unrepayable debt as to precipitate a macroeconomic crisis, much in the style of the Asian financial crisis. At the moment, it is posing problems in the banking system as most of the numerous banks are tiny, do not conform with international regulations and just act as treasuries to the respective industrial grouping.

As in the case of China, the faulty industrial structure does not mean that **Russia** is not capable of growing at a high rate for the next ten or even twenty years. One important condition for growth, especially in a setting where domestic competition is not strong, is an open economy, which would at least impose international competition. In terms of exports plus imports as a percent of GDP, **Russia** at 61% is at the international average given its population. But most of the country's exports constitute raw materials, mainly oil and gas. Fuels and energy were 58.7% of total exports in 2000 while total exports were 42% of GDP. In **Russia's** case, apart from a slow transition period, size has led to a lack of desire to open up the economy. It has been argued that high dependence on the energy sector could prove an obstacle to growth. As foreign exchange flows into the country, boosting money supply and inflation, with the nominal exchange rate fixed in **Russia's** case, the real exchange rate appreciates, hurting exports. But **Russia** is well placed to weather real exchange rate appreciation given that productivity growth was around 10 percentage points higher than real wage growth for the past two and a half years. While a lot of the recent improvement is indeed cyclical, talk of competitiveness loss due to real rouble appreciation in a country where average nominal wages are around 4% of Germany's seems unreasonable.

The small, fragile banking system and underdeveloped **capital markets** are a much greater obstacle to growth. The share of household deposits in GDP is just 5.5% while market capitalisation on the Moscow stock exchange is around 20% of GDP. The banking sector has begun to shift its focus away from government to commercial lending. Although this highly positive trend has come to stay, it does not alter the fact that the resources of the domestic banking sector are not enough to finance the needed high investment growth. Unlike China, **Russia** has not been able to attract much foreign direct investment. Both countries have a dysfunctional financial intermediation system which has prevented them transferring savings into productive investment. But in the case of **Russia** there were no huge FDI inflows to fill the gap. **Russia's** gross domestic savings to GDP ratio rose from 30.3% in 1990 to 38.2% in 2000 while gross domestic investment to GDP fell from 30.1% to 17.2% in 2000. The difference consists of a balance of payments surplus and capital exports of a massive 21% of GDP.

But with economic recovery and swelling profits in the oil and gas sector, Russian companies were able to draw on retained profits as a source for investment. Gross fixed capital formation grew strongly in 2000, up by 15.5% compared with 4.7% the year before and a fall of 10% in 1998. Investment growth slowed in the beginning of last year, but has accelerated strongly since the summer, resuming its position as **Russia's** growth engine. Fixed investment growth accelerated to 7.6% in the year to Q3, up from 3.3% in Q1. A faster published, but more limited measure for fixed investment rose by 11% in the year to October, up from 9.5% in the previous month. Investment, particularly growth of investment, continues to be heavily concentrated in the fuels and transportation sectors (a large part of the latter being fuel pipeline transport). These accounted for 40% of investment in Q1-Q3 and almost two-thirds of investment growth. With lower energy prices, exports revenues will diminish. But the oil price surge was largely saved abroad. If confidence in the economy improves, **Russia** has enough funds of its own to fuel high investment growth. Russian consumers and businesses are getting more optimistic about their country as the recent reversal in the up-to-now massive capital flight shows. We estimate that 8.5

Exhibit 20



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Country: Kazakhstan

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Report Title: KAZAKHSTAN COUNTRY COMMERCIAL GUIDE FY2002

Chapter #: 1:

Chapter: EXECUTIVE SUMMARY

This Country Commercial Guide (CCG) presents a comprehensive look at Kazakhstan's commercial environment, using economic, political and market analyses. The CCGs were established by recommendation of the Trade Promotion Coordinating Committee (TPCC), a multi-agency task force, to consolidate various reporting documents prepared for the U.S. business community. Country Commercial Guides are prepared annually at U.S. embassies through the combined efforts of several U.S. Government agencies.

In 2000, Kazakhstan's economy grew sharply, aided by increased prices on world markets for its leading exports (oil, metals, and grain). GDP grew 9.6% in 2000; GDP growth of just under 10% is expected again in 2001. The increased economic growth also led to a turn-around in government finances, with the budget moving from a cash deficit of 3.7% of GDP in 1999 to 0.1% surplus in 2000.

Kazakhstan has successfully reformed its financial sector. Monetary policy has been well run, managing to accommodate large foreign currency inflows over the last two years without sparking inflation, which has remained in single digits (9.7% in 2000). Spending restraint and recent strong revenues have kept the government budget relatively healthy. The National Bank has overseen a successful reform of the financial sector, which is beginning to serve as mediator between savers and investors. Kazakhstan created a system of privately managed individual accounts. Assets in the new pension system have grown to over \$1 billion in just three years. The pension system assets have contributed to a flourishing corporate bond market, which has harnessed these savings for private investment. Insurance companies are growing rapidly and the National Bank is pressing ahead with plans to create a secondary market in mortgage-backed securities.

Kazakhstan's natural resources have also been key to its current economic success. Oil and mineral exports have driven economic growth and attracted significant foreign investment -- over \$12 billion since 1993. The Tengiz oil field, developed by the TengizChevroil joint venture, established by the Government and Chevron in 1993 and subsequently expanded to include ExxonMobil and



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Chapter: **INVESTMENT CLIMATE STATEMENT**

A.1. Openness to Foreign Investment

The Government of Kazakhstan has made significant progress in creating a favorable investment climate since its independence in 1991. Kazakhstan has implemented a series of broad-based reforms in an effort to move from a planned economy to a market economy. These reforms include de-monopolization, privatization, debt restructuring, lifting profitability controls, price liberalization, customs reform, and tax reform. Kazakhstan also established a securities and exchange commission, liberalized trade, enacted laws on investment, set up an adequate government procurement process, and reformed the banking system.

The U.S.- Kazakhstan Bilateral Investment Treaty came into force in 1994. Key concerns remain, however, including the vagueness of laws, contradictory legal provisions, and poor implementation, especially at the local level of government. For instance, the lack of clarity in the 1995 Tax Code allowed for creative interpretations by the Tax Police and other government agencies. In June 2001, in an effort to improve tax administration, Kazakhstan adopted a new Tax Code that will go into effect starting January 2002. Customs officials often interpret customs regulations arbitrarily. The State Agency on Investments, established in late 1996 as a "one-stop shop" for foreign investors, was made a part of the Ministry of Foreign Affairs in spring 2001. It remains to be seen if this organizational move strengthens advocacy for foreign investors within the Government.

Since 1997, there has been a growing trend to favor domestic investors over foreigners in most state contracts. September 1999 amendments to the oil and gas law requiring oil companies to use local goods and services represent an extension of this trend. The Government continues to emphasize increasing domestic content in investments, particularly in the oil and gas sector. President Nazarbayev has complained publicly that previous privatizations were executed too quickly and did not allow for the involvement of domestic investors. Other government officials have further expressed the need to "protect" domestic producers from outside competition.

In the second half of 2001, the Government plans to submit to Parliament a new Investment Law that would replace the 1994 Law on Foreign Investment and 1997 Law on State Support for Direct Investment. The main goal of the new Investment Law is to establish a single investment regime regulating the activities of both domestic and foreign investors. The foreign business community in Kazakhstan is concerned that the new Investment Law would eliminate many benefits that foreign investors enjoyed under the 1994 Foreign Investment Law, including guarantees against changes in Kazakhstan's legislation and some customs duties exemptions. The new law would also limit recourse to international arbitration of investment disputes.

In January 2001, the GOK passed transfer pricing legislation, which gave tax and customs officials more authority to regulate export-import transactions. This law was enacted to stop capital flight from foreign owned companies in Kazakhstan to affiliated offshore companies. Foreign investors are concerned by the legislation's methods of determining the market price. The GOK is still in the process of drafting implementation regulations for this law.

In recent years, the GOK has enacted four major pieces of legislation affecting foreign investment. These are: 1) The Law on Foreign Investment, 1994 (amended in July 1997); 2) The Law on State Support for Direct Investment, 1997; 3) The Law on Government Procurement, 1997; and 4) The Tax Code of 2001. (Note: a new Investment Law may replace the Law on Foreign Investment and the Law on State Support for Direct Investment in 2001. See above.) These four laws provide for non-expropriation, currency convertibility, guarantee of stability in the legal regime, transparent government procurement, and incentives in certain priority sectors, including electrical infrastructure, telecommunications, light manufacturing, health and tourism.

However, poor implementation of these laws and reforms remains the key obstacle to business in Kazakhstan. Transparency in the area of government tenders remains an important concern.

Kazakhstan's generally liberal investment regime means that no sectors of the economy are closed to investors, although there are some sectoral limitations, such as a cap on the percentage of foreign capital in the banking system and other restrictions on media and telecommunications ownership. The GOK remains a player in attracting foreign investment. Foreign investment proposals are screened by government officials, sometimes at the highest level. Major projects, such as the Production Sharing Agreement (PSA) for the Kashagan offshore Caspian field and the Karachaganak PSA, bear the President's personal imprimatur. The screening process itself is not a significant impediment to investment in terms of limiting competition or protecting domestic interests. However, the process is often non-transparent and can slow investment decisions.

Tax experts consider Kazakhstan's tax laws to be among the most comprehensive in the CIS. In general, taxes are applied universally within the 2001 Tax Code, as well as the previous tax code, allowing only a limited set of

exemptions. The Code applies an international model of taxation, based on the principles of equity, economic neutrality and simplicity. The new Tax Code is widely seen as a further step forward in establishing a transparent and effective tax system. The GOK also reduced its VAT rates from 20% to 16% and its social taxes (payroll taxes) from 21% to 11% in 2001

In December 1996, the Treaty on the Avoidance of Double Taxation between the United States and Kazakhstan came into force. Since independence, Kazakhstan ratified treaties on the avoidance of double taxation with over 30 countries.

The administration of the Tax Code and the Tax Treaty has not been as efficient, transparent, or consistent as it should be. The GOK recognizes this, and began a program of reform. Nevertheless, U.S. and foreign firms often complain of harassment by the tax police via unannounced inspections and other methods. In 1998, the Government limited the number of visits that can be made by government bodies in the course of a year to small businesses, but tax inspections were excluded from this limitation.

The 2001 Tax Code simplified and clarified the previous tax code. The new Tax Code limits the powers of tax authorities and defines the rights of taxpayers more clearly. The challenge for the Government will be implementing the tax code regulations and transfer pricing legislation.

Since 1995, the Government has wholly privatized many large-scale companies and sold majority shares in other companies to foreign investors. Privatization moved ahead quickly in 1996 and into the summer of 1997 in all sectors of the economy, including oil and gas, power generation, coal, and telecommunications. In early 1998, however, citing low oil prices, President Nazarbayev announced the Government would suspend future privatizations in the oil and gas sector. A much-discussed program to privatize shares of the remaining large state enterprises, "Blue Chip Privatization," has remained stalled.

Both the 1994 Foreign Investment Law and the latest draft 2001 Investment Law provide for, inter alia, guarantees for national treatment and non-discrimination among foreign investors. Generally, Kazakhstan allows investment in any sector with some limitations in certain sectors, such as the 1998 National Security Law that limits foreign ownership of individual media companies to 20%. Kazakhstani law does not subject foreign investment to any prior authorization requirements.

Despite the general guarantee, at present, there exists a possibility of denial of national treatment in the petroleum and subsurface utilization (minerals) sectors. Amendments to the laws regulating these activities, published September 1, 1999, require investors to contract with Kazakhstani service providers, and to purchase Kazakhstani equipment, goods and raw materials so long as these meet the requirements for participating in government tenders. The law requires that an unnamed government body review all service contracts to ensure compliance with these requirements. However, implementing regulations to the law have not yet been issued, and it remains unclear how these requirements will be implemented. The requirements may be challenged prior to Kazakhstan's hoped-for WTO accession negotiations since they appear to breach GATT and

the financial system is only beginning to mediate financial resource flows and direct them to the most promising parts of the factor and product markets. Nevertheless, official policy is clearly supportive of credit allocation on market terms and the further development of legal, regulatory and accounting systems that are consistent with international norms.

Most domestic borrowers receive credit from Kazakhstani banks. However, foreign investors find the margins taken by local banks and the security required for credit to be very onerous. It is usually cheaper and simpler for them to use retained earnings or borrow from their home country. Kazakhstan's stock exchange is tiny and, as such, not yet a realistic source of funds (see below). Kazakhstani banks have, since 1998, placed Eurobonds on international markets and obtained syndicated loans, the proceeds of which have been used to support domestic lending. Leading Kazakhstani banks have been able to obtain reasonably good ratings from international credit assessment agencies. All Kazakhstani banks have been required to meet Basle risk-weighted capital standards. The National Bank supervises the banking system and has overseen a steady consolidation and strengthening of the system.

With the implementation of deposit insurance in November 1999, private deposits in the banking system grew from less than \$300 million in November 1999 to roughly \$720 million in March 2001.

A market for debt securities has been rapidly developing in Kazakhstan. In a period of 21 months ending June 30, 2001, the volume of corporate debt securities in Kazakhstan has grown from zero to more than \$210 million. Several dozen bank and non-bank corporations – large and small – have issued bills, notes and bonds with maturities ranging from three months to seven years. Earlier issues have matured and been redeemed and, so far, there have been no defaults. Kazakhstan's pension system reform has boosted the bond market by creating a pool of capital, now about \$1 billion, managed by private pension funds.

In April 2000, the GOK placed its fourth Eurobond, a seven-year \$350 million issue. Previous sovereign Eurobonds were placed in December 1996 for \$200 million, in September 1997 for \$350 million and in September 1999 for \$200 million. In December 1999, the Government paid off the principal on its first, \$200 million Eurobond, issued in 1996. The Government plans to place the next Eurobond issue in 2002.

The Kazakhstan Stock Exchange (KASE) has been in operation since September 1997. As of July 2001, there were 12 "A-listed" companies, six "B-listed" and 30 Over the Counter (OTC) stocks. Inadequate financial records prevent many other companies from being put on the exchange. Moreover, company managers fear diluting control of their enterprises by selling more shares. In the second half of 1998, the Government decided to postpone the sale through the exchange of shares in four or five "blue chip" companies until investors' interest in the emerging markets recovers. The sales, which were planned for 1999-2000, have not taken place as of July 2001.

Non-Ferrous Metals	1830.2	77.4	51.2	1958.8
Ferrous Metals	335.6	12.5	17.8	365.9
Electric Power	254.4	86.2	23.4	364
Food Processing	237.2	42.9	47.7	327.8
Communications	209.5	4.6	5.5	219.6
Others	889.1	185.2	130.2	1204.5
Total	6696.0	1233.3	1799.3	9728.6

FDI Stock (2000) as a Percentage of GDP (2000) = 68.3%

FDI Flows as a Percentage of GDP:

1997	1998	1999	2000
9.4%	5.7%	11.4%	15%

Largest Investments as of June 2001:

1. TengizChevrOil (TCO) and Caspian Pipeline Consortium (CPC). TCO, a joint venture founded between Kazakhstanmunaigaz and Chevron, was formed as part of a 40-year, \$20 billion agreement signed in 1993. Mobil obtained a 25-% share in the joint venture in 1996. In March 1997, Chevron sold a 5-% share of TCO to the Russian company, LUKoil. By 2001, the joint venture partners had invested more than \$2.1 billion in TCO, which is producing 290,000 barrels of oil a day. These companies are also major shareholders, along with the Government of Russia, in the Caspian Pipeline Consortium project, a pipeline from the Caspian across southern Russia to the Black Sea. The \$2.5 billion pipeline began transporting Tengiz crude to world markets in summer 2001.

2. Philip Morris signed an agreement with the Almaty Tobacco Company in 1993, under which Philip Morris pledged to invest \$350 million through 1998. The project is considered to be one of the largest privatization efforts in the former Soviet Union. Philip Morris has been producing cigarettes in Kazakhstan for domestic consumption since 1994. In spring 2000, Philip Morris completed its \$200 million greenfield cigarette manufacturing plant in Almaty Oblast. The plant is slated to produce over 25 billion cigarettes annually.

3. In 1993, the Offshore Kazakhstan International Operating Company (OKIOC), consisting of nine international petroleum companies (BP-Amoco, Statoil, British Gas, Royal Dutch Shell, Mobil, Agip, Inpex, Philips and Total), began seismic work to explore oil and gas reserves in the northern section of the Caspian Sea. A production sharing agreement (PSA) was signed in November 1997 for the offshore Kashagan structure. In July 2000, OKIOC formally announced that it had discovered oil at its first exploratory well. Further testing and drilling will be necessary to establish the volume of reserves, but if early estimates are proven,

Exhibit 21

RUSSIA

TRADE SUMMARY

In 1999, the United States trade deficit with Russia was nearly \$4 billion, an increase of \$1.8 billion from the 1998 deficit of just over \$2.1 billion. U.S. merchandise exports to Russia were \$1.8 billion in 1999, a decrease of \$1.7 billion (48.5 percent) from the level of U.S. exports in 1998. Russia was the United States' 41st largest export market in 1999. U.S. imports from Russia accounted for approximately \$5.8 billion in 1999, a decrease of \$71 million (1.2 percent) from 1998. The stock of U.S. foreign direct investment in 1998 was \$1.1 billion, a 46.6 percent decline from 1997.

The U.S.-Russia Trade Agreement governs all trade relations between the United States and Russia. The USSR signed the agreement in June 1990, and it was approved by the U.S. Congress in November 1991. The agreement, however, never reached ratification during the existence of the USSR, and the United States offered the agreement (with minor technical changes) to each of the emerging states of the former Soviet Union. Russia's parliament approved the agreement, making it possible for the United States to extend Most-Favored-Nation (now Normal Trade Relations or NTR) status to Russia on June 17, 1992. Russia is in the process of negotiating terms of accession to the World Trade Organization (WTO). By the end of 1999, the government of Russia had met nine times with WTO members in working party meetings. Russia tabled its initial goods and services market access offer in February 1998 and October 1999, respectively, and will discuss its plans to bring its laws into line with WTO provisions at the tenth Working Party session, expected to meet in the first half of 2000.

IMPORT POLICIES

Frequent and unpredictable changes in Russian customs regulations have created problems for foreign and domestic trade and investment, and

a burdensome import licensing regime for alcohol has depressed imports in that sector. However, at the end of 1999, the most significant factor affecting U.S. exports was the difficult economic situation in Russia subsequent to the August 1998 financial crisis. The devaluation of the ruble puts imports at a price disadvantage, and reduced consumption overall has also depressed imports. Other significant negative developments in the foreign trading environment include the reduced availability of trade and non-trade finance and disruptions to the distribution chain.

Since 1995, Russian tariffs have generally ranged from five to thirty percent, with a trade-weighted average in the range of 13 to 15 percent. In addition, excise and value-added taxes (VAT) are applied to selected imports. The VAT, which is applied to the price of the import plus its tariff, is currently 20 percent. Some food products have a VAT rate of 10 percent. Throughout 1999, some tariff revision occurred. In some cases tariffs dropped on inputs needed by Russian producers in the electronics and furniture business. On the other hand, there have been sharp hikes in tariffs on sugar and pharmaceuticals, including high seasonal tariffs on raw and processed sugar. In particular, compound duties with minimum tariff levels on poultry enacted in 1998 had the effect of increasing *ad valorem* duties after the fall in poultry prices in 1998-99. The Ministry of Trade, supported by the State Customs Committee, has proposed the reduction of some of Russia's higher tariffs, noting that very high tariffs only lead to evasion. The government, however, has been reluctant to approve wholesale reductions in tariffs given acute revenue concerns, as customs duties account for a significant percentage of total federal revenues (about 20 percent).

Other Russian tariffs that have stood out as particular hindrances to U.S. exports to Russia include those on autos, where combined tariffs and engine displacement-weighted excise duties can raise import prices of larger U.S.-made

RUSSIA

The review process for granting licenses to telecommunications providers in Russia through the Ministry of Telecommunications lacks transparency. U.S. telecommunications companies have criticized the five-year term of the licenses, which they argue do not allow them sufficient time to recoup their investment.

Central Bank regulation 721-U effective December 31, 1999 requires that payments of greater than \$10,000 for imported services must receive advance permission from the federal service for currency and export control. While it is intended as an anti-capital flight measure, and while it has been in effect for too brief a period to gauge its real impact, implementation of the rule could disadvantage foreign service exporters to Russia.

INVESTMENT BARRIERS

A Bilateral Investment Treaty (BIT) was signed between the United States and Russia in June 1992. The treaty was approved by the U.S. Senate in October of the same year, but it cannot enter into force until approved by the Russian Duma. The Duma did not actively consider ratification of the BIT in 1999.

Despite the passage of a new law regulating foreign investment in June 1999, Russian foreign investment regulations and notification requirements can be confusing and contradictory. The law on foreign investments provides that a single agency (still undesignated) will register foreign investments and that all branches of foreign firms must be registered. The law does codify the principles of national treatment for foreign investors, including the right to purchase securities, transfer property rights, protect rights in Russian courts, repatriate funds abroad after payment of duties, and receive compensation for nationalizations or illegal acts of Russian government bodies. However, the law goes on to state that federal law may provide for a number of exceptions, including, where necessary, for "the protection

of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state." The potentially large number of exceptions thus gives considerable discretion to the Russian government. The law also provides a "grandfather clause" that existing "priority" foreign investment projects with foreign participation over 25 percent be protected from unforeseeable changes in the tax regime or new limitations on foreign investment. The definition of "priority" projects is not fully clear, although it appears that projects with a foreign charter capital of over \$4.1 million and with a total investment of over \$41 million will qualify. In addition, although the situation has improved over the past few years, foreigners encounter significant restrictions on ownership of real estate in some cities and regions in Russia.

Current Russian legislation restricts foreign investment in the aerospace industry to 25 percent of an enterprise. Foreign investments in the natural gas monopoly Gazprom are limited to 20 percent and in the electrical power giant Unified Energy Systems to 25 percent. However, these limits have not been strictly enforced and current foreign holdings in these two entities is believed to exceed these limits by a small amount. The Duma is also considering draft legislation which would prohibit and/or allow restriction of foreign investment in a wide range of sectors in the economy.

The Russian tax system is a key concern of foreign investors. Although part I of a major tax code reform was passed in July 1998, legislative consideration of the second half of the reform (defining specific rates) was largely stalled in 1999. The Duma did pass changes to the personal income tax which reduced the number of tax brackets from six to three and reduced the maximum tax rate from 45 percent to 30 percent. These changes take effect January 1, 2000. The Duma also expanded the list of goods taxed at the lower 10 percent VAT rate. VAT law amendments signed by Acting President Putin in